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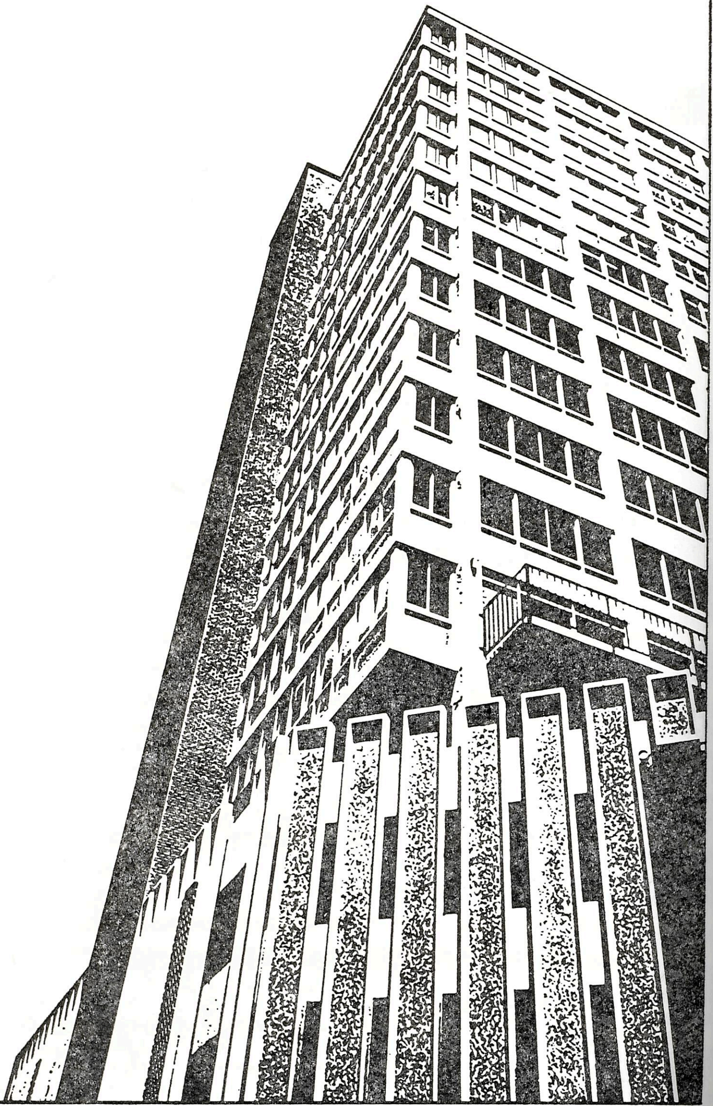

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DENVER LAW JOURNAL

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BASIS ASPECTS OF A TRANSFER OF A PARTNERSHIP INTEREST AND DISTRIBUTION

BY MAXWELL A. SNEAD*

Literature on the income tax basis ramifications of transfers or distributions of partnership interests is notably lacking in legal scholarship. Mr. Snead analyzes this subject with a view toward the tax consequences of the possible adjustments to basis which are available under the Code when a transfer or distribution of a partnership is made. He combines an analysis of the Code and the Regulations with examples of the practical workings of the various sections discussed. His article concludes with a discussion of allocation of basis under the adjustment rules and the elections under Sections 754 and 755 of the Code.

CONTENTS

* Associate, Dawson, Nagel, Sherman & Howard; B.S., University of Denver, 1965; J. D., University of Denver, 1969; C.P.A., 1969.

INTRODUCTION

THE stated objectives of the draftsmen of subchapter K[1] of the 1954 *Internal Revenue Code* were "simplicity, flexibility, and equity as between the partners."[2] One of the areas of federal partnership income tax law in which the draftsmen appear to have fallen short of their stated objectives[3] is the matter of basis. More than one-third of the sections within subchapter K are addressed to basis determination.[4] Furthermore, it is often necessary to refer to the *Code's* basis rules of general application contained in subchapter 0.[5]

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[1] INT. REV. CODE of 1964, §§ 701-71.

[2] S. REP. No. 1622, 83rd Cong., 2d Sess. 89 (1954).

[3] Dealing with the question of whether a transaction constituted the sale of an interest or the liquidation of an interest, Raum, J. made the following critical comment: "Although there can be little doubt that the attempt to achieve 'simplicity' has resulted in utter failure, the new legislation was intended to and did bring into play an element of 'flexibility.'" David A. Foxman, 41 T.C. 535, 551 (1964).

[4] Ten of the 27 sections of subchapter K contain the word "basis" in their titles. They are: § 705, Determination of Basis of Partner's Interest; § 722, Basis of Contributing Partner's Interest; § 723, Basis of Property Contributed to Partnership; § 732, Basis of Distributed Property Other Than Money; § 733, Basis of Distributee Partner's Interest; § 734, Optional Adjustment to Basis of Undistributed Partnership Property; § 742, Basis of Transferee's Partner's Interest; § 743, Optional Adjustment to Basis of Partnership Property; § 754, Manner of Electing Optional Adjustment to Basis of Partnership Property; § 755, Rules for Allocation of Basis.

[5] INT. REV. CODE of 1954, §§ 1011-23.

An understanding of the complexities of these basis sections is a necessary prerequisite to successful partnership tax planning.

The purpose of this paper is to examine the basis provisions of the 1954 *Code* that apply to the transfer of a partnership interest by a partner and to the distribution by the partnership of assets to a partner. With respect to a transfer, examination will be made of the basis aspects of the transferee's interest. Distributions present basis determination problems for the distributee and the partnership. In both areas, the *Code* provides general rules governing basis but alternative treatment is made available by election. Elections available to the partnership may have a significant impact on the present and future movement of persons and property into and out of the partnership structure. A partner may have a separate election available with significant income tax consequences. In turn, a decision to make one of the elections raises additional important issues.

The provisions of the *Code* to be examined herein clearly reflect a theoretical difference of opinion about the nature of a partnership that has continued to exist in the state law of partnerships, as well as in the federal income taxation of that form of business enterprise. The conflict exists on the question of whether a partnership is a separate entity or an aggregate of persons. "The entity theory treats the partnership itself as having an existence apart from the partners and as such it is capable of engaging in business transactions in its own right, apart from the partners themselves."[6] On the other hand, "[t]he aggregate or the conduit concept views a partnership as an association of individuals. Such concept does not recognize the business organization as having any existence apart from the individual partners."[7] The entity versus aggregate debate highlighted discussions that attended the drafting of the Uniform Partnership Act. The language of the Act supports the conclusion that both theories were embodied, although perhaps inadvertently, in the final draft.[8] Decisions of courts construing the Act have taken different positions on the question of what theory governs. On the one hand, the partnership has been treated as a separate legal person apart from the individual partners;[9] on the other, a clear intent to adopt the aggregate theory has been found by some courts.[10]

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[6] Anderson & Coffee, *Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K*, 15 TAX. L. REV. 285, 287 n.9 (1960).

[7] *Id.* at 287 n.10.

[8] E. WARREN, CORPORATE ADVANTAGES WITHOUT INCORPORATION 293-301 (1929); Jensen, *Is a Partnership Under the Uniform Partnership Act an Aggregate or an Entity?*, 16 VAND. L. REV. 377 (1963).

[9] Note, *The Partnership as a Legal Entity*, 41 COLUM. L. REV. 698 (1941).

[10] Helvering v. Smith, 90 F.2d 590 (2d Cir. 1937).

The entity versus aggregate distinction prevails in the basis provisions of the 1954 *Code*.[11] The general approach is the entity theory, with the result that a clear distinction is drawn between a partner's basis in his partnership interest and the partnership's basis in its assets. Upon the initial contribution of assets to the partnership, the partners' bases for their partnership interests equals the partnership's basis in the contributed assets,[12] but thereafter the respective bases are subject to changes which may affect one but not the other. The draftsmen of the *Code* embodied the aggregate theory of partnerships in the form of optional adjustments to the basis of partnership property to bring the separate bases to the same amount in the case of certain distributions and transfers. These different approaches, allowed by the 1954 *Code,* and their ramifications are the principal topics of this paper.

With certain notable exceptions, *e.g.*, the family partnership, the partnership provisions of the *Code* have not been the subject of extensive litigation. In the absence of case law, reliance must be placed upon congressional hearings, the income tax regulations, revenue rulings, authors of law review articles and books, and statutory interpretation by the writer.

A. *Subjects Not Covered*

For purposes of this discussion, the assumption implicit throughout is that the partnership, either regular or limited, is a statutory partnership within the *Code*,[13] and that no election to be treated otherwise has been made.[14] Except as otherwise noted, partnership property does not include unrealized receivables[15] or substantially appreciated inventory.[16] The matter of termination of the partnership[17] is considered where pertinent, but otherwise it is assumed that distributions and transfers do not have such an effect.

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[11] *See generally* Anderson & Coffee, *supra* note 6, at 286-89; Jackson, Johnson, Surrey & Warren, *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners — American Law Institute Draft,* 9 TAX L. REV. 109 (1954); B. Wolfman, *Level for Determining Character of Partnership Income — "Entity" v. "Conduit" Principle in Partnership Taxation,* 19 N.Y.U. INST. ON FED. TAX, 287 (1961).

[12] INT. REV. CODE of 1954, §§ 722, 723.

[13] The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate, or corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

INT. REV. CODE of 1954, § 7701(a)(2).

[14] *Id.* § 761(a).

[15] *Id.* § 751(a-c).

[16] *Id.* § 751(a,b,d).

[17] *Id.* § 708(b).

I. Transfers of a Partnership Interest

Although the emphasis of this discussion is directed to the special problems of the transferee of a partnership interest, it is important to be cognizant of the tax consequences to the transferor of a partnership interest because of their impact on negotiations in the case of a sale, and taxation in the case of death. Of equal significance is a description of the types of transactions which are treated as a "transfer of a partnership interest" as that terminology is used in the *Code*.

When a partner sells a part or all of his partnership interest to one or more of the other partners, or to one or more outsiders, he recognizes gain or loss on the transaction.[18] The nature of the underlying partnership assets determines the character of the gain or loss recognized. If the partnership has section 751 property, *i.e.*, unrealized receivables[19] or inventory items which have substantially appreciated in value,[20] separate treatment is accorded such assets,[21] and a two-step computation is required, which in effect treats the gain allocable to the 751 property as ordinary income. First, a proportion of the sale price is allocated to the section 751 assets on the basis of the values contained in the agreement between buyer and seller if the transaction is at arm's-length or, in the absence of an agreement on value, on the basis of the fair market value of

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[18] *Id.* §§ 741, 751.

[19] Unrealized receivables are defined by the 1954 *Code* to include,

> to the extent not previously includible in income under the method of accounting used by the partnership, any right (contractual or otherwise) to payment for — (1) goods delivered or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered.

INT. REV. CODE of 1954 § 751(c). Unrealized receivables also includes the selling partner's share of the amount that would be treated as ordinary gain (1) from the sale of section 617 mining property (property in relation to which the partnership elects to deduct exploration expenditures subject to recapture), (2) from the sale of section 1245 property, and (3) from the sale of section 1250 property, as if such section 617, 1245, or 1250 property had been sold by the partnership at its fair market value. Generally, the agreement between the buyer and seller as to the value of such property establishes its fair market value. *Id.;* Treas. Reg. § 1.751-1(c)(4) (1965).

[20] Substantial appreciation is defined by the *Code* as fair market value in excess of "(A) 120 percent of the adjusted basis to the partnership of such property, and (B) 10 percent of the fair market value of all partnership property, other than money." INT. REV. CODE of 1954, § 751(d). The definition of inventory items has broad coverage. As the name suggests, it includes stock in trade or property held for resale in the ordinary course of business. In addition, (1) partnership property which, on sale or exchange by the partnership, is not considered a capital asset or a section 1231 asset (for example, the *Regulations* point out that unrealized receivables are also "inventory items"), (2) certain foreign investment company stock, and (3) property, whether a capital asset or a section 1231 asset or not, which would be an inventory item to the selling partner or the distributee, are included in the definition of inventory items. *Id.* § 751(d)(2).

[21] INT. REV. CODE of 1954, § 751(a).

such property at the date of sale of the partnership interest.[22] For purposes of determining gain or loss, the basis of the section 751 property in the hands of the selling partner is, in most cases,[23] equal to the basis to the partnership of the selling partner's proportionate share of those assets immediately before the sale of the interest.[24] The selling partner's proportionate share of the partnership's adjusted basis for section 751 property is apparently based on his capital ratio.[25] Where the capital and profit ratios are the same, no conceptual difficulties are encountered. However, where the capital and profit ratios are different, the employment of the capital ratio will produce a questionable, and perhaps unexpected, result.[26] The difference between the allocated sale price and the basis of the section 751 assets is ordinary gain or loss.[27] The second step consist of finding the difference between the remaining balance of the sale price and the basis of the remainder of the partnership interest (*i.e.*, as reduced by the section 751 allocation).[28] This amount is capital gain or loss.[29]

When the partnership does not have unrealized receivables or inventory items which have substantially appreciated in value, capital gain or loss results as measured by the difference between the amount realized (the sale price) and the partner's adjusted basis of his partnership interest.[30]

A distinction should be made between the acquisition of a partnership interest by the contribution of money or property to the partnership and the acquisition of a partnership interest by purchase from a partner or partners. This same distinction is made in accounting terminology by referring to the former type of acquisition as "investing in a partnership" and to the latter type as

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[22] Treas. Reg. § 1.751-1(a)(2) (1965).

[23] If the basis to the partnership exceeds the partner's basis in his partnership interest, the basis for section 751 property is limited to the latter. INT. REV. CODE of 1954, § 732(a),(b); Treas. Reg. § 1.751-1(a)(2) (1965).

[24] *Contra,* Barnes v. United States, 253 F. Supp. 116 (S.D. Ill. 1966). This case is discussed in the text accompanying footnote 68, *infra.*

[25] *See* Treas. Reg. § 1.751-1(g) (example 1) (1965).

[26] When the cash-basis partnership collects its receivables or sells its appreciated inventory, the resulting income is divided among the partners in the profit and loss ratio. Where the profit and loss ratio differs from the capital ratio, a shifting of ordinary income from one partner to another results when section 751 is applied. Section 751 was intoduced to combat the "collapsible partnership," *i.e.* the conversion of ordinary income into capital gain by the sale of a partnership interest. Although it accomplishes this result, it may result in inequity among the partners if the capital ratio, rather than the profit and loss ratio, is employed in the allocation required by section 751.

[27] INT. REV. CODE of 1954, § 751(a).

[28] Treas. Reg. § 1.751-1(a)(2) (1965).

[29] INT. REV. CODE of 1954, § 741.

[30] *Id.* §§ 741, 1001.

"purchasing a partnership interest."[31] Apart from its application in the personal service partnership area, acquisition of an interest by investment may arise where an existing partnership needs additional money or property to expand its business. Where a contribution of assets is made to a partnership as an investment, the person acquiring a partnership interest does not recognize gain or loss, and the amount of money or his adjusted basis in the property[32] contributed becomes his basis in the partnership interest acquired.[33] Neither the partnership nor the other partners recognize gain or loss upon the contribution of money or property to the partnership in exchange for a partnership interest.[34] This rule applies regardless of whether the contribution is made during the formation stage of the partnership or after it is already in existence.[35] Although both the *Code* and the *Regulations* do not so specify, it seems clear that the nonrecognition rules applicable to contributions govern the situation where a new partner is admitted to the partnership as a result of a contribution that increases partnership capital in the same manner as the contribution by a person already a partner. However, when the investment method is the first step of what is in reality the sale of a partnership interest, the Internal Revenue Service may be expected to recharacterize the transaction to reflect its true nature.[36]

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[31] For a detailed discussion of this distinction and the accounting treatment for both methods see H. FINNEY & H. MILLER, PRINCIPLES OF ACCOUNTING: ADVANCED 17-23 (5th ed. 1963). "[P]artnership admissions are of two general classes: (1) The new partner *purchases* all or a part of the interests of one or more old partners and makes payment to them; [and] no new funds come into the partnership. (2) The new partner *invests* assets in the partnership; [and] the partnership funds are thus increased." *Id.* at 17.

[32] The aspects of the admission of a service partner where another partner relinquishes his right to the return of part of his capital contributions, thus giving rise to ordinary income to the service partner, are considered in Treas. Reg. § 1.721-1(b) (1960). Services, as consideration for a partnership capital interest, are not "property" as that term is used in the text.

[33] INT. REV. CODE of 1954, §§ 721, 722.

[34] *Id.* § 721.

[35] Treas. Reg. § 1.721-1(a) (1960).

[36] H. FINNEY & H. MILLER, *supra* footnote 31, make the following observations on goodwill and bonus in the investment context:

> When a new partner is admitted, the old partners may be allowed goodwill or a bonus in recognition of the profitable business they have developed.
>
> Goodwill:
>
> > If goodwill is to be allowed the old partners, it should be placed on the books before the admission of the new partner, and the credit therefore should be divided between the old partners in their profit and loss ratio.
>
> A bonus:
>
> > Instead of setting up a Goodwill account, the old partners may require that part of the capital contributed by the new partner be

credited to their accounts. Such a bonus should be credited to the old partners in their profit and loss ratio.

On the other hand, the new partner may be allowed goodwill or a bonus in recognition of a high earnings potential which he is bringing to the business.

Goodwill:

If goodwill is allowed the new partner, the entry for his admission should contain a debit to Goodwill.

A bonus:

A bonus to a new partner is recorded by making transfers from the capital account of the old partners to the capital account of the new partner, thus giving the new partner a total capital credit greater than the amount of his investment. Such a bonus should be charged to the old partners in their profit and loss ratio.

. . . .

To illustrate, assume that A and B have capitals of $10,000 and $20,000, respectively, with a 50:50 profit and loss ratio, and that C is to be admitted as a partner by making a contribution to the firm capital.

Goodwill allowed to old partners. Assume that the problem states that C is to invest, and obtain a capital credit of, $11,000, which is to be one-fourth of the total capital. The total capital, therefore, is to be $44,000. The capitals of A and B plus C's contribution amount to $41,000; therefore, there is a goodwill of $3,000. Since C's capital credit is equal to his contribution, the goodwill is allowed to A and B, by credits of $1,500 to each.

Bonus allowed to old partners. C is to invest $14,000, the total capital is to be $44,000 and C is to have a one-fourth interest therein. Since C invests $14,000 and receives a capital credit of only $11,000, A and B will be credited with $3,000 of C's contribution as a bonus, shares in the profit and loss ratio.

Goodwill allowed to new partner. C is to transfer, at a valuation of $8,000, the assets of a business he has been conducting. C is to have a one-fourth interest in an agreed capital of $40,000. Since the capitals of A and B plus C's contribution amount to $38,000, there is a goodwill of $2,000. Since C contributes $8,000 and is credited with $10,000, he must receive the credit for the goodwill.

Bonus allowed to new partner. C is to invest $8,000; the agreed capital is to be $38,000; and C is to have a one-fourth interest therein. The capitals of A and B plus C's contribution amount to $38,000; therefore, there is no goodwill. But since C invests $8,000 and receives a capital credit of $9,500, a $1,500 bonus is allowed to him; A and B are charged $750 each.

Id. at 25.

It must, of course, be remembered that the values assigned to capital contributions by the partners are, except in the case of cash contributions, independent of the income tax basis of the assets to the partnership. The partnership does not terminate for income tax purposes because operations would not be discontinued and a contribution of property, including money, is not a "sale or exchange" under section 708(b)(1)(B). Treas. Reg. § 1.708-1(b)(1)(ii) (1960).

Where goodwill is allowed to either the old partners or to the new partner, no adverse tax consequences would arise. In both situations, goodwill represents pre-contribution appreciation in the value of the assets and section 704(c) clearly allows such treatment as a reflection of the economic realities. Where bonus is allowed, however, the transaction takes on the appearance of a contribution coupled with a purchase. In the absence of a restriction upon the withdrawal of capital, where bonus is allowed to the old partners, the incoming partner, C, has immediately relinquished his right to receive $3,000 on liquidation and that amount is available for distribution to partners A and B. Assuming that the capital accounts of the old partners are the same as their respective bases for their partnership interests, the investment by C of $14,000 is (1) a contribution of $10,000 and (2) the purchase of an additional capital interest of $1,000 by the payment to A and B of $4,000. Capital gain treatment on the purchase part of the transaction may result. This same reasoning may be applied to bonus allowed to the new partner to find a bargain purchase.

Neither the *Code* nor the *Regulations* treat this problem specifically but Treas. Reg. § 1.721-1(b)(1) implies such a result. This problem is also discussed in Note, *Some Tax Consequences of Partnership Readjustments,* 67 HARV. L. REV. 360 (1954).

The investment method of acquiring an interest is not within the scope of the discussion that follows.

Upon the death of a partner, three possibilities exist with regard to ownership of the interest. Depending upon the provisions of the partnership agreement,[37] the deceased partner's successor in interest may: (1) continue as a partner, (2) sell the partnership interest to one or more of the partners, or (3) receive distributions from the partnership in liquidation of the interest. Common to (1) and (2) is the present statutory scheme establishing the following tax pattern: recognition of gain or loss by the deceased partner because diminution or appreciation in the fair market value of the partnership interest is foreclosed by the death of the partner;[38] depending upon the size of the deceased partner's estate, estate tax[39] may or may not be incurred as to the partnership interest; and regardless of whether estate taxes are incurred, the deceased partner's successor in interest receives the partnership interest with a new basis for income tax purposes. The new basis may be higher or lower than the deceased partner's basis before death. The new basis is the fair market value at the date of death or the alternative valuation date[40] plus the successor's share of partnership liabilities, if any, and minus income in respect of a decedent included in the amount of fair market value.[41] If the interest is sold by the decedent's successor in interest to one or more of the partners, the seller recognizes gain or loss in the same manner as previously described.

If the agreement provides for liquidation of the partnership interest by the partnership, the rules of section 736[42] apply. The *Code* allows the partners to determine among themselves the tax consequences of retirement of a partnership interest by liquidation. The provisions of section 736 are quite complex. For present pur-

[37] *Uniform Partnership Act* § 31(4) (1914) provides that the death of a partner shall dissolve the old partnership. Some states have amended the uniform act to provide for an agreement to the contrary. *See* Bromberg, *Partnership Dissolutions, Causes, Consequences, and Cures,* 43 TEX. L. REV. 631 (1965). Some courts have given effect to the terms of a partnership agreement or a provision in a deceased partner's will providing for a continuation of the partnership. *See* Note, *Partnership: Continuation of the Business Upon the Death of a Partner,* 20 OKLA. L. REV. 456 (1967); Note, *Partnership Continuation Agreements,* 72 HARV. L. REV. 1302 (1959). For income tax purposes, the death of a partner, in and of itself, does not terminate the partnership, even in the case of a two-man partnership. Treas. Reg. § 1-708-1(b) (1960).

[38] INT. REV. CODE of 1954, § 1014.

[39] In the case of a deceased partner survived by a spouse, the present statutory scheme generally allows a gross estate of approximately $120,000 to go untaxed. *Id.* §§ 2031, 2051, 2052, 2056.

[40] INT. REV. CODE of 1954, § 1014(a).

[41] Treas. Reg. § 1.742-1 (1960).

[42] INT. REV. CODE of 1954, § 736(b).

poses, it is enough to note that payments made under section 736 whether made as a distributive share of income, as a guaranteed payment, for goodwill, or for an interest in the partnership, are not considered a sale, exchange, or transfer upon death, within the scope of transfers of a partnership interest.[43] The distribution aspects of section 736 are discussed *infra* in section III of this article.

The distinction between the sale of an interest after the death of a partner and liquidation of that interest by the partnership is of utmost importance.[44] To the successor in interest, the method chosen will make the difference between capital gain or ordinary gain.[45] To the remaining partners, a capital investment or reduced taxable income are the alternative consequences.[46] The *Code* puts the parties on opposite sides of the negotiating table for the reason that "one of the underlying philosophic objectives of the 1954 Code was to permit the partners themselves to determine their tax burdens *inter sese* to a certain extent . . . ."[47]

When a transaction constitutes the transfer of a partnership interest, the transferee of that interest determines his basis by reference to sections 742 and 743 of the *Code*. To summarize, transactions which are treated as a transfer of a partnership interest, and thereby bring into operation the transferee basis provisions of the *Code*, are: the sale or exchange of a partnership interest by a partner or by the partner's successor in interest and the transfer of an interest by death. The statutory language "transfer . . . upon

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[43] Treas. Reg. § 1.736-1(a) (1965).

[44] In an exhaustive analysis of cases in which the distinction between a sale and a liquidation was paramount, one author has concluded that the intent of the parties as manifested by the location of the obligation to make payments controls. Swihart, *Tax Problems Raised by Liquidation of Partnership Interests,* 44 TEX. L. REV. 1209 (1966). For a case dealing with the distinction between a sale and a liquidation in the context of a buy-sell agreement funded with life insurance under a "cross-purchase" plan or an "entity" plan, *see* Victor G. Mushro, 50 T.C. 43 (1968); *see also,* Comment, *Planning the Tax Consequences of Partnership Agreements, Funded With Life Insurance, to Provide for Disposition of a Deceased Partner's Interest,* 30 MO. L. REV. 117 (1965).

[45] David A. Foxman, 41 T.C. 535 (1964). The court made the following observation:

> If the transaction were a "sale" under section 741 Jacobowitz's [the retiring partner] gain would be taxed as capital gain (there being no section 751 problem in respect of unrealized receivables or inventory items which have appreciated substantially in value), and would be reported in 1957 [the year of the sale] rather than in 1958 [the close of the partnership fiscal year]. On the other hand, if the transaction were a section 736 "liquidation," the amounts received by him (to the extent that they were not for his "interest . . . in partnership property" pursuant to section 736(b)(1)) would be taxable as ordinary income and reportable by him in 1958 rather than 1957. The tax liabilities of the remaining partners . . . would be affected accordingly, depending upon whether section 736 or 741 governed the transaction.

Id. at 550 n.7.

[46] *Id.*

[47] David A. Foxman, 41 T.C. 535, 551 (1964).

the death of a partner" is apparently synonymous with the phrase "acquired from . . . the decedent" as used in the basis provisions of section 1014(b).[48] It appears that a court ordered sale of partnership assets, depending on the facts and circumstances of each case, may be the sale of a partnership interest.[49] The basis provisions of section 743 are not operative when a partnership interest is acquired by contribution to an existing partnership or in a partnership liquidation of an interest. Furthermore, no suggestion is made in the *Code* or *Regulations* that the gift of a partnership interest is to be treated as a transfer of a partnership interest for purposes of the basis provisions of Sections 742 and 743, and it must be assumed that the basis provisions of the *Code* relating to a donee's basis, control.[50]

A. *The General "No Adjustment" Rule*

The entity approach to partnership tax law is readily apparent in the general rule of transferee basis upon the transfer of a partnership interest. It will be recalled that the entity approach views the partnership as separate and apart from the individual partners. In the corporate income tax area, the purchaser of stock takes as his basis in the shares the amount of money or other consideration paid for it,[51] without regard to the proportionate amount of the adjusted basis of the corporate assets that the purchased shares represent. This same theory was applied to transfers of partnership interests before its statement as the general rule in the 1954 *Code*.[52] The rule was succinctly stated as follows: "A partnership's basis in its assets is distinct from the partners' bases in their partnership interests, and is not affected by changes in such partnerhip interests."[53] In some cases based on pre-1954 law, taxpayer attempts to step up the basis of partnership assets were successful on the grounds that, under state law, the old partnership had terminated.[54] The 1954 *Code* settled earlier confusion and negated reliance on

[48] Dupree v. United States, 391 F.2d 753, 758 (5th Cir. 1968) (community property transfer).

[49] *See* Rev. Rul. 264, 1966-2 CUM. BULL. 248. The ruling cited the following facts: as a result of litigation among the five equal partners, the court ordered judicial sale of the *partnership assets;* three of the five partners bought the assets and continued the business; the other two partners received their respective share of the sales proceeds in liquidation of their interests.

[50] INT. REV. CODE of 1954, § 1015 (a,d).

[51] INT. REV. CODE of 1954, § 1012.

[52] Robert E. Ford, 6 T.C. 499 (1946); G.C.M. 26379, 1950-1 CUM. BULL. 212, *revoking* G.C.M. 10092, XI-1 CUM. BULL. 114 (1932).

[53] Rev. Rul. 144, 1953-2 CUM. BULL. 212, 213.

[54] Milton H. Jacobs, 14 CCH Tax Ct. Mem. 637 (1955); *contra,* Anderson v. United States, 232 F.2d 794 (9th Cir. 1956).

state law by establishing definitive rules governing termination of a partnership.[55]

Upon the transfer of a partnership interest by sale or exchange, or upon the death of the transferor, the new basis for the partnership interest to the transferee shall be its cost where sold or exchanged,[56] or the fair market value of the interest at the date of the transferor partner's death or one year thereafter.[57] Unless otherwise elected, no adjustment to the basis of partnership property to reflect differences between the market value of the assets of the business and the partnership's adjusted basis of those assets may be made.[58] Although the sales price of, or the estate tax valuation of, the partnership interest reflect appreciation or diminution in the value of the partnership assets, the basis of the underlying assets, upon which the value of the partnership interest was determined, remains separate and distinct under the general rule.

Perhaps the most illuminating method of demonstrating the principal topic of this discussion — the operation of the adjustment to basis provision of section 743(b) — is to consider in detail the effects of the general rule, mindful that the optional adjustment approach alleviates the problems described. It is quite clear that when the sales price, or the fair market value for estate tax purposes, of the transferred partnership interest equals the adjusted basis of that portion of the partnership assets attributable to the transferred partnership interest, no benefit nor detriment accrues to the transferee as a result of the application of the general rule. Therefore, an election to adjust the basis of partnership assets would be inconsequential. It is also clear that such equality of bases is a rare occurrence. Consideration must therefore be given to the effect of the general no-adjustment rule on post-transfer depreciation, depletion, gain, or loss from the sale of partnership assets and distributions.

Where the partnership has property that has appreciated in value and a partnership interest is transferred, the transferee encounters adverse tax consequences as a result of the application of the general rule. The appreciation in the value of the partnership assets is reflected in the price that he paid for the partnership interest, or its fair market value at the death of the transferring partner, but not in the transferee's proportionate share of the part-

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[55] INT. REV. CODE of 1954, § 708(b).

[56] *Id.* §§ 742, 1012.

[57] *Id.* §§ 742, 1014.

[58] *Id.* § 743(a).

nership's asset basis. To illustrate, the ABCD partnership has the following assets, liabilities, and capital:[59]

Assets	Adjusted Basis	Market Value
Cash	$ 1,000	$ 1,000
Accounts Receivable	2,000	2,000
Inventory	6,000	6,400
Building (net of straight-line depreciation)	5,000	7,000
Land	1,000	1,200
Royalty Interest in Oil and Gas Property	1,000	2,400
Total Assets	$16,000	$20,000
Liabilities & Capital		
Liabilities	-0-	-0-
Capital Accounts — A	$ 4,000	$ 5,000
— B	4,000	5,000
— C	4,000	5,000
— D	4,000	5,000
Total Liabilities and Capital	$16,000	$20,000

Assume that A sells his interest to E for $5,000 and that an election under section 754[60] to adjust the basis of partnership assets pursuant to section 743(b) is not in effect. E's basis for the purchased partnership interest is his cost, $5,000, pursuant to section 1012. The underlying partnership assets attributable to E continue to have a basis of $4,000 under the general rule of section 743(a). During the taxable year of the partnership, the following events occur: (1) the inventory is sold for its market value of $6,400; (2) depreciation on the building amounts to $250 for the year; (3) royalty income is received and the partnership elects to take a percentage depletion of $300 since cost depletion would have amounted to $200 or one-fifth of the adjusted cost basis to the partnership. E's distributive share of income and expenses are: ordinary income from the sale of inventory, $100; depreciation on the building, $62.50; depletion, $75.

The detrimental consequences to E may be readily demonstrated. Had E purchased one-fourth of the assets of the partnership, instead

[59] The type of assets and the amounts used are not intended to depict an actual partnership, but rather are chosen as a vehicle for discussion purposes.

[60] *See* section V *infra.*

of purchasing a partnership interest based on the value of partnership assets, the income and expense picture would have been much different. His basis in each asset would have been:

Cash	$ 250
Accounts Receivable	500
Inventory	1,600
Building	1,750
Land	300
Royalty Interest	600
Total	$5,000

Based on the same transactions detailed in the preceeding paragraph, E would: (1) have no income upon the sale of the inventory items, (2) have depreciation on the building of $87.50, (3) have taken cost depletion, rather than percentage depletion, in the amount of $120.00 (1/5 of $600).

In the absence of the election under section 732(d),[61] the general rule of section 743(a) also has an adverse effect on E when he receives a current or liquidating distribution of the appreciated property. Assume that E receives, as a current distribution from the partnership, one-fourth of the royalty interest in oil and gas property. E takes as his basis the partnership's adjusted basis,[62] $250.00 (1/4 of $1,000) instead of $600, the amount for which he would have purchased the interest apart from the partnership interest. Cost depletion would be limited to the $250 carryover basis. Furthermore, if E then sold the royalty interest for $600 (the amount of his original cash outlay allocable to the asset), he would realize a capital gain of $350. Distributions will be discussed in more detail later in this article.

If the ABCD partnership had section 751 assets at the time E purchased his interest, the general rule would prohibit a special basis adjustment in the absence of a proper partnership election. Thus, if the ABCD partnership's accounts receivable were, instead, unrealized receivables, the basis of the unrealized receivables would be zero as to the transferee's share and upon collection would result in $500 ordinary income to E. Other section 751 assets which could be expected to appear in this context are substantially appreciated inventory and section 1231 assets with potential section 1245 or 1250 income.

61 *See* section II *infra.*

62 INT. REV. CODE of 1954, § 732(a).

Whereas the purchase of an interest in a partnership with appreciated assets has an undesirable immediate impact on the purchaser, the purchase of an interest in a partnership that has assets which have declined in value has a favorable effect on the purchaser. The decline in the value of the partnership assets is reflected in the price he paid, or in the fair market value at the death of the transferring partner, for the partnership interest but not in his acquired share of the partnership assets. To illustrate, the FGHI partnership has assets, liabilities, and capital of:

Assets	Adjusted Basis	Market Value
Cash	$ 1,000	$ 1,000
Accounts Receivable	2,000	2,000
Inventory	6,000	4,000
Building	5,000	4,000
Land	1,000	500
Royalty Interest in Oil and Gas Property	1,000	500
Total Assets	$16,000	$12,000
Liabilities & Capital		
Liabilities	- 0 -	- 0 -
Capital — F	$ 4,000	$ 3,000
— G	4,000	3,000
— H	4,000	3,000
— I	4,000	3,000
Total Liabilities and Capital	$16,000	$12,000

Assume that F sells his interest to J for $3,000 and the section 754 election is not made. J's basis for the purchased partnership interest is its cost, $3,000, pursuant to section 1012. No change is made in the basis of the partnership assets attributable to his interest, which is $4,000. During the partnership taxable year, the following transactions take place: (1) the inventory is sold for its market value of $4,000; (2) depreciation on the building amounts to $250 for the year; (3) royalty income is received and the partnership computes depletion, based on cost, which amounts to $200 or one-fifth of the adjusted basis to the partnership. The partnership transactions have the following effect on J: ordinary loss from the sale of inventory, $500; depreciation expense, $62.50; depletion, $50.

In this situation, the tax consequences to J are immediately beneficial. Had he purchased the assets rather than an interest in the partnership, his basis in each asset would have been:

Cash	$ 250
Accounts Receivable	500
Inventory	1,000
Building	1,000
Land	125
Royalty Interest	125
Total Basis	$3,000

The transactions, if J had purchased the assets, would result in: (1) no gain or loss from the sale of the inventory, (2) reducing depreciation on the building to $50, and (3) reducing cost depletion to $25.

If J receives a current distribution of property that has declined in value, his basis in the distributed property is the same as it was in the hands of the partnership, provided it does not exceed his basis in his partnership interest. Hence, if one-fourth of the royalty interest is distributed to J, his basis for purposes of cost depletion or for a subsequent sale is $250, whereas the market value of the royalty interest is $125.

The preceding examples illustrate the immediate tax consequences of the general "no adjustment" rule of section 743(a), but the overall effect of that rule on the transferee must be considered. First, however, an understanding of the operation of another basis provision of the *Code* is necessary. The transferee's cost basis for his partnership interest is increased by his distributive share of partnership taxable income and decreased by: (1) distributions of money or property, and (2) his distributive share of partnership losses; but in no event shall the decreases result in a negative basis.[63]

When a sale by the partnership of assets which had increased or decreased in value at the time the transferee received his interest is followed by a liquidation of the transferee's interest, a variety of results may occur. Where the partnership has appreciated assets, the sale of the assets produces gain to the transferee partner and his basis is increased in the amount of the gain. If the transferee's interest is then liquidated by a cash distribution[64] after two years

[63] *Id.* § 705(a)(1)(A).

[64] Where a distribution is of property and the fair market value of the distributed partnership property other than money is, at the time of the transfer of the partnership interest, in excess of 110 percent of its adjusted basis to the partnership, section 732(d) must be applied. *See* section II *infra*.

from transfer of the interest,[65] the relief provisions of section 732(d) discussed in section II *infra* would not be available and a capital loss is incurred by the transferee. Isolating the two transactions, the amount of the capital loss on liquidation would equal the amount of the transferee partner's distributive share of the partnership's gain on the sale of the appreciated partnership assets. To illustrate, assume that L purchases a partnership interest for $5,000. The partnership assets attributable to L's interest have an adjusted basis of $4,600 and the difference between the purchase price of the interest and the adjusted basis of the underlying assets represents appreciation in the value of those assets. Upon the sale by the partnership of those assets for $5,000, L's distributive share of taxable gain is $400 and the basis of his partnership interest is increased to $5,400 ($5,000 cost plus taxable income of $400). After two years, L's interest is liquidated by a cash distribution. Since the partnership received $5,000 for the assets, that is the extent of the money that L receives. L has incurred a capital loss of $400 ($5,400 adjusted basis in partnership interest, minus $5,000 cash received in liquidation of his interest).[66] If the appreciated assets were capital assets, capital gain upon the sale by the partnership would be offset by capital loss on the liquidating distribution. However, if the appreciated assets were other than capital assets, *e.g.* inventory, ordinary gain to L would have been the result of the partnership's sale of those assets. Therefore, ordinary gain upon the sale is offset by capital loss on the distribution. Where the partnership has assets that have declined in value at the time of the purchase of the partnership interest, the assets are sold by the partnership, and the transferee partner's interest is liquidated by a cash distribution, the tax results are ordinary or capital loss on the sale, depending upon the type of asset, and capital gain on the cash distribution. Careful analysis demonstrates that the tax consequences do not necessarily "even out in the end."

If the transferee, instead of receiving a liquidating distribution, sells the partnership interest, the tax consequences are generally the same. Assuming a stable market value of the partnership assets, a sale by the transferee immediately after receipt of the partnership interest would result in neither gain nor loss since the sale price (market value) of the interest would equal the basis of the transferee-seller.[67] If the sale of the partnership interest by the transferee occurs after the sale by the partnership of the assets which had

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[65] Section 742(d) may not be applied by the transferee after two years from the acquisition of the interest. *See* section II *infra*.

[66] INT. REV. CODE of 1954, § 731(a)(2); Treas. Reg. § 1.731-1(a)(2) (1956).

[67] INT. REV. CODE of 1954, § 1001.

increased or decreased in value at the acquisition of the interest, or after depreciation or depletion is taken on such assets, the resulting tax consequences are the same as described in the immediately preceding paragraphs where the transferee's interest is liquidated by a cash distribution. The same ordinary income-capital loss and ordinary loss-capital gain possibilities exist here as well.

The propriety of two taxable events with regard to one asset of the partnership — recognition on the sale by the partnership and recognition on subsequent liquidation or sale of the transferee's partnership interest — was recently raised in *Barnes v. United States*.[68] The transferee taxpayer had purchased an interest in a professional partnership which had unrealized receivables which were subsequently collected. No election to adjust basis was made and the taxpayer reported the collection of the receivables as ordinary income. At the time when the taxpayer sold his partnership interest, the receivables of the partnership were in excess of the amount at the time of the taxpayer's purchase of the interest. The taxpayer successfully argued that section 751, requiring ordinary income treatment of unrealized receivables owned by the partnership at the time of the sale, should not be applied to that portion of the unrealized receivables which were equal to the unrealized receivables at the acquisition of the taxpayer's interest. To illustrate, let us assume that A purchases a partnership interest for $6,000. The underlying partnership assets are unrealized receivables with a basis of zero and a fair market value of $3,000 and other assets with an adjusted basis and fair market value of $3,000. The receivables are collected, A reports his distributive share as $3,000 of ordinary income, and his partnership interest basis is increased to $9,000 ($6,000 cost plus $3,000 distributive income). At this point, if A sold his interest or received a liquidating distribution, he would incur a capital loss of $3,000 since the partnership would have money and porperty with an adjusted basis and fair market value of $6,000 attributed to A's partnership interest. This demonstrates the ordinary income-capital loss pattern previously mentioned. If, instead of liquidating or selling his interest, A works in the partnership until the partnership has again accumulated $3,000 in unrealized receivables and then A sells his interest for $9,000 ($3,000 cash from unrealized receivables collected, $3,000 market value of other assets, and $3,000 in new unrealized receivables), section 751 requires separate treatment of the unrealized receivables. At this point, A's partnership interest basis is still $9,000 since the unrealized receivables have no effect on his basis until collected. Section

[68] 253 F.Supp. 116 (S.D. Ill. 1966).

751 produces $3,000 ordinary income (fair market value less the partnership's basis of O carried over to A). This leaves $6,000 of the purchase price ($9,000 total purchase price less $3,000 allocated to unrealized receivables) to be offset by A's partnership interest basis of $9,000. Therefore, A also has a $3,000 capital loss on the transaction.

In *Barnes*, the court concluded that the $3,000 of unrealized receivables were being taxed too many times and that the taxpayer should be allowed to recoup his cost in the unrealized receivables. While it expressed doubts as to the constitutionality of the result required by the *Code*, the court rested its decision on two rather strained reconstructions of the transaction.

The case is significant in two aspects. First, the holding of the case proceeds entirely upon the assumption that when A bought into the partnership he purchased the underlying assets rather than the partnership interest — an assumption clearly in opposition to the theory of the *Code* and prior case law.[69] In the absence of this assumption regarding the purchase, the application of section 751(a) to the sale of the interest is clearly within the Congressional purpose of preventing the conversion of ordinary income into capital gain. Second, the position asserted by the court would make resort to the elective special basis adjustment provision of section 743(b) unnecessary where section 751 is applicable.

The devastating impact that the general rule of section 743(a) may have upon the unwary taxpayer was recently demonstrated in *Dupree v. United States*.[70] The factual pattern, in chronological order, may be summarized as follows: (1) a transfer upon the death of a partner; (2) a sale by the partnership of a capital asset that had appreciated greatly before the death of the partner; (3) a liquidating distribution of cash and a proportionate interest in notes taken by the partnership from the purchaser of the capital asset; and (4) the death of the transferee partner. Relief under section 732(d) was not available because the distribution occurred more than two years after the transfer of the interest. The sale of the capital asset resulted in a substantial amount of capital gain which amount was, pursuant to section 705, added to the transferee's partnership interest basis. It should be noted that the facts of the case introduce two elements not previously considered herein — a property distribution and death of the transferee-distributee. The *Code* provides for recognition of loss on a distribution in liquidation only in the event cash, unrealized

[69] INT. REV. CODE of 1954, §§ 741-42; First Nat'l Bank of Mobile v. Commissioner, 183 F.2d 172 (5th Cir. 1950), *cert. denied* 340 U.S. 911 (1951); Commissioner v. Long, 173 F.2d 471 (5th Cir. 1949).

[70] 391 F.2d 753 (5th Cir. 1968).

receivables, or inventory are distributed.[71] The distribution of any property delays the recognition of a loss until the subsequent disposition of the property by the partner.[72] The transferee partner's basis in the partnership interest, after the reduction for the cash received, became his basis in the distributed property. Just as described in the previous examples of appreciated assets and liquidation after their sale, the basis in the transferee's partnership interest exceeds the transferee's proportionate share of assets before the liquidating distribution. Therefore, upon liquidation Dupree had a tax basis in excess of the fair market value (and for that matter, in excess of the face amount) of the notes. The capital loss that would have been realized upon collection on, or sale of, the notes, which would have offset the capital gain recognized on the partnership's sale of its asset, disappeared, much to the chagrin of his successors in interest, at his death.[73] There is, of course, "no equity in tax law."[74]

Three final comments are relevant to *Dupree* specifically and to the general rule of section 743(a). First, whenever the tax pattern is ordinary income or capital gain upon the sale of assets by the partnership and capital loss, upon liquidation of the partnership interest and the taxable events occur in different years, the capital loss may only be carried forward[75] and, in the absence of capital gains in the future, will offset up to $1,000 of ordinary income until the capital loss is used up or expires at the death of the taxpayer.[76] Accordingly, the result may be a heavy tax burden initially, followed by slow and uncertain recoupment. Where the tax pattern is ordinary loss or capital loss upon the sale of assets by the partnership and capital gain upon liquidation of the partnership interest capital gain (partnership with assets that have declined in value), the same problem does not exist. Second, death of a transferee partner in the *Dupree* situation, but with assets that have declined in value at the time of the transfer of the partnership interest, will allow the transferee's successors in interest a stepped-up basis with no capital gain treatment under existing law. Finally, and as an introduction to the next section, an election to adjust the basis of partnership assets for Dupree's benefit would have cancelled out his distributive share of the gain on the sale of the asset and made his death an innocuous tax event.

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[71] INT. REV. CODE of 1954, § 731(a)(2); Treas. Reg. § 1.731-1(a)(2) (1956).

[72] INT. REV. CODE of 1954, §§ 731(a)(2), 732(b).

[73] *Id.* § 1014.

[74] Dupree v. United States, 391 F.2d 753, 758 (5th Cir. 1968).

[75] INT. REV. CODE of 1954, § 1212.

[76] *Id.* § 1211.

B. *Optional Adjustment to Basis of Partnership Assets*

The alternative approach provided by section 743(b) clearly demonstrates an aggregate approach to partnership income tax law. It has the effect of treating the transferee of a partnership interest as the owner of his proportionate share of the individual partnership assets apart from the collective group. The partnership form that stands between the transferee under the general "no adjustment" rule of section 743(a) is removed by the operation of the basis adjustment alternative.

The special basis adjustment provision is not operative unless the election required by section 754 is in effect.[77] The *Code* contains specific rules for allocating the adjustment once it has been made.[78] A limited alternative is available under section 732(d) to the transferee when the adjustment rule is not utilized.[79]

The amount of the adjustment to the basis of the partnership property is determined by comparing the transferee partner's basis for his interest in the partnership with his proportionate share of the adjusted basis of the partnership assets. The adjusted basis of the partnership assets is increased by the excess of the basis of the transferee's partnership interest over the transferee's proportionate share of the adjusted basis of the partnership assets. A decrease results where the latter exceeds the former.[80]

The ABCD partnership example[81] may be used to illustrate the operation of the special basis adjustment that increases the adjusted basis of partnership assets. E purchased for $5,000 partner A's one-fourth interest in the partnership. E's proportionate share of the adjusted basis of partnership assets is $4,000. The special basis adjustment is $1,000.

Likewise, the FGHI partnership example [82] provides a vehicle for the illustration of the operation of the special basis adjustment that decreases the adjusted basis of partnership assets. J purchased F's one-fourth interest in the partnership for $3,000. J's proportionate share of the adjusted basis of partnership assets is $4,000. The special basis adjustment is a minus $1,000.

The adjustment to the basis of partnership assets is for the benefit of the transferee.[83] Although the adjustment is made by

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[77] *See* section V *infra.*

[78] *See* section IV *infra.*

[79] *See* section II *infra.*

[80] INT. REV. CODE of 1954, § 743(b).

[81] *See* p. 345, *supra.*

[82] *See* p. 347, *supra.*

[83] Treas. Reg. § 1.743-1(b) (1956).

the partnership, the adjustment by itself has no effect on the other partners.

For purposes of computing the transferee partner's distributive share of depreciation, depletion, and gain or loss from the sale of partnership property and for determining basis upon the distribution of partnership property to the transferee, the special basis adjustment becomes a part of the basis of partnership assets.[84] The special basis adjustment is allocated to assets in a manner which reduce the difference between fair market value of the assets and the adjusted basis of the assets to the partnership.[85]

When the BCDE partnership sells its inventory that has an adjusted basis of $4,600 for $5,000, the gain is $400. However, the transferee partner's one-fourth share of the gain, $100 is offset by the special basis adjustment of $100 attributable to the inventory. A post-acquisition increase or decrease in the market value of the inventory would result in gain or loss, respectively, to the transferee.

When the GHIJ partnership sells its inventory with an adjusted basis of $6,000 for the market value of $4,000, a $2,000 loss results. Again, however, the special basis adjustment attributable to the transferee J's proportionate share of the inventory nullifies his distributive share of the loss. A post-acquisition change in value would also create gain or loss to the transferee.

When the special basis adjustment is allocated to depreciable partnership property and is an increase to the adjusted basis of that property, the transferee's depreciation is increased although there is no change in the method that the partnership uses in computing depreciation. A special basis adjustment that decreases the adjusted basis of depreciable property, of course, results in lower depreciation to the transferee. It should be noted that accelerated methods of depreciation, when used for partnership property to which the special basis adjustment is applicable, may not be applied to the special basis adjustment that increases the adjusted basis of that property.[86] If the special basis adjustment decreases the adjusted basis of property on which accelerated methods of depreciation are applied by the partnership, the transferee partner must report income in the amount of the difference between the accelerated method and the straight-line method.[87]

If the partnership has depletable property, cost depletion is affected in the same manner as depreciation, but the *Regulation's* approach to accelerated methods of depreciation on the special basis

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[84] *Id.*

[85] INT. REV. CODE of 1954, § 755(a)(1); *see* section IV *infra.*

[86] Treas. Reg. § 1.167(c)-1(a)(6) (1956).

[87] *Id.*

adjustment has not been carried over to the depletion area. The *Code* goes even further in giving a special "tax break" to the transferee of an interest in a partnership that has property subject to depletion by providing that "any depletion allowable shall be determined separately for the transferee partner with respect to his interest in such property."[88] "If a transferee partner has paid a high price [or if the transferee partner received the partnership interest upon the death of his predecessor in interest at a fair market value that reflects a substantial increase over the adjusted basis of the partnership assets] for his partnership interest, he may find it advisable to use cost depletion at the same time that other partners use percentage depletion."[89]

If the transferee receives a distribution of partnership property to which the special basis adjustment applies, the basis of the property in his hands includes the special basis adjustment. If another partner receives a distribution of that property, the special basis adjustment will shift from the distributed property to other partnership property. The shifting special basis adjustment is one of the topics included in section IV *infra.*

Because of the effect that the optional adjustment rule of section 743(b) has in reconciling the basis of the tranferee's partnership interest and the adjusted basis of the underlying partnership assets, the variety of post-acquisition income tax consequences of a subsequent liquidation or sale of the transferred interest encountered in the application of the general "no-adjustment" rule do not arise with the application of the optional adjustment rule. The pattern of "gain now-loss later," or vice versa, and the danger of a "gain now-loss never" *Dupree* result do not exist since the initial taxable event in those patterns does not occur under section 743(b).

The *Regulations* contain several provisions intended to clarify the effect of certain transactions which occur after the transfer of the partnership interest and the application of section 743(b). One provision deals with the subsequent transfer of the transferred interest and is designed to prevent the multiplication of special basis adjustments — a possibility clearly not intended by the draftsmen — and to allow, on the other hand, the subsequent transferee the full benefit of the purchase price of the interest. To illustrate, assume that A, B, and C contribute $5,000 each and that D contributes land with an adjusted basis and market value of $5,000. When the land has appreciated in value to $9,000, A sells his one-fourth interest

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[88] INT. REV. CODE of 1954, § 743(b); *see also* Neel v. United States, 266 F. Supp. 7 (N.D. Ga. 1968).

[89] 1 Z. CAVITCH, BUSINESS ORGANIZATIONS § 802(3) (1968).

to E for $6,000 (¼ of the value of partnership assets). E has a special basis adjustment of $1,000. The land appreciates still further to $13,000 and E sells the partnership interest to F for $7,000 (¼ of the new value of partnership assets). Does F have a special basis adjustment of $3,000 (E's adjustment of $1,000 plus F's adjustment of $2,000) or does F have a special basis adjustment of $1,000 (the purchase price less E's share of the assets and E's special basis adjustment)? In both instances, the *Regulations* would say no. F's section 743(b) adjustment is determined by referring to the common basis of the partnership property without regard to E's section 743(b) adjustment. Therefore, F's special basis adjustment is $2,000 (the purchase price less transferee's proportionate share of the common partnership basis or $7,000 minus ¼ of $20,000).[90]

Section 743(b) also provides that a section 704(c)(2) agreement between the partners shall be taken into account in determining the special basis adjustment. The *Code* recognizes that the partners may agree that precontribution appreciation or depreciation in value of the contributed property shall be allocated to the contributor upon subsequent disposition of that property by the partnership.[91] Where the contributor of the property that had increased or decreased in value from its adjusted basis before contribution transfers his partnership interest, the transferee computes his special basis adjustment by including the precontribution change in value with his proportionate share of postcontribution change in value (as reflected by the difference between the purchase price of the interest and the transferee's proportionate share of the adjusted basis of partnership property.[92]

A deficit balance in the capital account of the transferor may create some confusion when the transferee computes his special basis adjustment. The capital account must be carefully distinguished from the adjusted tax basis of a partnership interest. The former may, of course, have a negative balance but the latter may never be reduced below zero.[93] Assuming that, (1) the transferor's capital account showed a deficit balance of $2,000, (2) his proportionate share of the adjusted basis of partnership assets is zero, and (3) he sells his interest for $5,000, the transferee's special basis adjustment is $5,000. The deficit account balance, if there is an obligation on the transferor to repay "is a loan governed by section 707(a) of the Code."[94] If the transferee had assumed the transferor's

[90] Treas. Reg. § 1.743-1(b)(2)(ii) (1956).

[91] INT. REV. CODE of 1954, § 704(c)(2); Treas. Reg. § 1.704-1(c)(2)(i) (1964).

[92] Treas. Reg. § 1.743-1(b)(2)(i) (1956).

[93] INT. REV. CODE of 1954, § 705(a)(2).

[94] Rev. Rul. 318, 1957-2 CUM. BULL. 362, 363.

obligation to repay the deficit, it seems definite that the transferee's basis adjustment would, instead, be $7,000.

C. *Summary Comparison of Section 743(a) and Section 743(b)*

It should be apparent that the general "no adjustment" rule operates for the benefit, tax-wise, of the transferee when the price he paid for the partnership interest, or the fair market value at the date of the death of the transferee's predecessor in interest, is less than the transferor's proportionate share of the adjusted basis, for income tax purposes, of partnership assets. He receives the advantage of a higher depreciation and, perhaps higher depletion, than his purchase price would warrant had he purchased only the assets apart from the partnership. He may be able to trade an ordinary loss for a later capital gain, depending on the nature of partnership assets. Should the transferee die after an ordinary or capital loss is incurred but before a liquidating distribution of cash, or after a liquidating distribution of property still held at his death, the present statutory scheme will not tax the built-in capital gain. Because of these factors, the transferee would have little, if any, interest in the alternative rule of section 743(b).

On the other hand, the alternative rule embodied in section 743(b) is most attractive to the transferee of an interest in a partnership where his basis in that interest exceeds his proportionate share of partnership assets. He receives the full benefit of his cost, or the fair market value at his transferor's death, in computing depreciation or depletion on property that has appreciated in value. Depletion may be computed independent of the method used by the partnership. He is not subject to realized gain on the preacquisition appreciation to the value of partnership assets. Tax traps, as demonstrated by the *Dupree* case, do not exist. Movement out of the partnership is facilitated since section 743(b) makes immaterial, in regard to preacquisition appreciation, the type of partnership property chosen for a distribution liquidating his interest.

In light of the preceding discussion, it should be readily apparent that the income tax ramifications of the transfer of a partnership interest on the transferee are of utmost significance. Serious attention must be directed not only to the short range income tax effects on the transferee but also to the long range consequences of the transfer.

The purpose of the foregoing discussion has been to examine in depth the basis provisions of the *Code* and to isolate their effect on the transferee of a partnership interest; but that is only part of the story. The choice of the basis rule to be applied rests with the partnership, not solely with the transferee partner. The reason for this is that the choice may, and probably will, to a limited extent, affect the other partners both as to past transfers and distributions and those that occur in the future. The problem of the partnership election is the subject of section V *infra.*

II. DISTRIBUTIONS TO THE TRANSFEREE OF A PARTNERSHIP INTEREST SUBJECT TO THE GENERAL RULE OF SECTION 743(a)

Section 1A *supra,* emphasized the serious tax consequences that a transferee of a partnership interest may encounter as a result of the application of the general rule that the adjusted basis of partnership assets is not changed by the sale, exchange, or inheritance of a partnership interest. If the basis of the transferee's partnership interest reflects an appreciation in the value of the underlying partnership assets in excess of the adjusted basis of those assets to the partnership, the full tax advantage of the partnership interest basis is denied the transferee and adverse income recognition may occur. The draftsmen of the *Code* recognized the problems inherent in the general rule of section 743(a)[95] and provided for a limited form of relief for the transferee by the enactment of section 732(d).[96] The "consideration" for the relief provision was the mandatory application of that *Code* section in certain circumstances.

A. *Adjustment at the Election of the Transferee Partner*

As will be described *infra,*[97] the election to adjust the basis of partnership assets is a matter for the collective determination by the partners. The advantages of the election may be far outweighted by the disadvantages that are a part of the election and the result may well be a refusal by the other partners to make the election for the benefit of the transferee. Section 732(d) may be used by the transferee to avoid the operation of the general "no adjustment" rule. Although this provision of the *Code* does not require a collective decision by the partnership to make it operative in an income tax sense, an examination of the provision will make it obvious that the collective decision may still be the determining factor.

If certain enumerated conditions are satisfied, section 732(d) allows the transferee, at his election, to treat as the adjusted partnership basis of the distributed property the adjusted basis such property would have had if the optional adjustment rule of section 743(b) had been in effect at the acquisition of the transferee's interest in the partnership.

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95 S. REP. NO. 1622, 83d Cong., 2d Sess. 391 (1954).

96 INT. REV. CODE of 1954, § 732(d).

97 *See* section V *infra.*

The transferee may elect to have section 732(d) applied if five conditions are met. They are: (1) a distribution of property; (2) the distributee must be a transferee as that term is used in section 743; (3) the distribution must be made within two years of the acquisition by the transferee of a partnership interest; (4) the alternative adjustment rule of section 743(b) must not have been in effect; and (5) a proper election must be made in the manner required by the *Regulations*.[98]

The first requirement contains two elements — a distribution and property. The former may be a current or liquidating distribution.[99] The need for a distribution is easily understood when it is recalled that the alternative adjustment rule requires the partners, rather than the transferee partner alone, to decide upon the use of the alternative rule and its application to partnership property. If a distribution was not required, an alternative to the alternative rule would exist. The transferee partner alone could make the decision to adjust partnership property — a result clearly negated by the express provision of section 743(b). Therefore, a distribution is required and the transferee-distributee's decision affects distributed property which is no longer partnership property.

The distribution to which the special basis adjustment applies must be of property. A fundamental principle of tax law that money cannot have a basis different from its face amount stands behind the applicability of section 732(d) to property other than money. Therefore, in the case of a current distribution of money, or if the transferee's interest is liquidated by a cash distribution, the transferee could not elect section 732(d) treatment. The transferee who receives cash in liquidation of his interest would face the results encountered under the general "no adjustment" rule of section 743(a) described in section 1A *supra.*

The Congressional proceedings[100] definitely support, and the language of the Code may be construed so as to support, the position that the property to which section 732(d) may be applied must be the identical property to which an adjustment to basis under section 743(b) would have been allocated at the time of the transfer of the partnership interest. The *Regulations* take the position that section 732(d) may be applied to both the identical property to which an adjustment to basis pursuant to section 743(b) would have been made and to "like property" if the transferee relin-

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[98] INT. REV. CODE of 1954, § 732(d).

[99] *Id.* The fact that the *Code* uses the word "distribution" generally, seems to indicate that it should apply to both types of distributions.

[100] S. REP. NO. 1622, 83d Cong., 2d Sess. 392 (1954).

quishes his interest in the identical property.[101] "Like property" is not defined in the regulation dealing with section 732(d), but because of that section's interrelationship with section 743, it may be concluded that the definition of the term for purposes of section 743 also applies to section 732(d). Therefore, "like property" is "property of the same class, that is, stock in trade, property used in the trade or business, capital assets, etc."[102] The position taken by the *Regulations* seems more logical and is justified in light of the purpose of section 732(d), *i.e.* to give the transferee the benefit of the provisions of the alternative adjustment rule of section 743(b) in a manner that does not do harm to the general "no adjustment" rule of section 743(a) or to the restriction in section 743(b) that a special basis adjustment is a matter for partnership determination. It is no more than an extension of the concept that a special basis adjustment may shift from one item of property to another.[103]

The second condition to the applicability of section 732(d) is that the distributee must be a transferee as that designation is used in section 743. As used there, a transferee is one who receives a partnership interest as a result of a sale or exchange, or by inheritance.

Requirements (3) and (4) are self explanatory. The election required of the transferee is discussed in section V *infra*.

It seems advisable to consider the operation of section 732(d) as, by election, it applies to certain distributions in the context of two now familiar situations — the transferee of a partnership interest whose basis of the interest is greater than his proportionate share of the adjusted basis of partnership property, and the transferee whose proportionate share of the adjusted basis of partnership assets exceeds the adjusted basis of his partnership interest. In both cases, the partnership did not elect to adjust the basis of partnership assets pursuant to section 743(b).[104] The former type of transferee and his situation will be referred to as "appreciated assets" and the latter type as "diminished-value assets." Two different kinds of distributions may be involved in either case. In the examples that follow it is assumed that the conditions imposed by section 732(d) have been, or can be, met.

1. Appreciated Assets — Current Distribution

A current distribution of an asset with a market value in excess of its adjusted basis to the partnership, at the time of acquisition

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[101] Treas. Reg. § 1.732-1(d)(1)(v) (1956).
[102] Treas. Reg. § 1.743-1(b)(2)(ii) (1956).
[103] *Id.*
[104] *See* p. 357, *supra*.

of the partnership interest by the transferee, will allow the transferee to avoid the detrimental tax consequences which he would otherwise encounter. To illustrate, assume that three parcels of real estate held for investment are among the assets of the LMN partnership. Each parcel has an adjusted basis to the partnership of $1,000. At a time when each parcel has a market value of $1,200, L sells his partnership interest to P for an amount which reflects L's one-third interest in the property and its appreciation. Section 743(b) is not made applicable. The partners agree to distribute one parcel of land to P in return for a partnership agreement provision that P will not share in the preagreement appreciation in the value of the other parcels. Under the *Code* provisions concerning the basis to the distributee of partnership property received in a current distribution, the adjusted basis of the distributed property to the partnership carries over to the distributee[105] subject to the limitation, not applicable here, that the basis in the hands of the distributee may not exceed his partnership interest basis.[106] Under the general rule, P's basis for the distributed property would be $1,000. However, if P elects to make section 732(d) applicable, the basis in his hands of the real property would be $1,200 ($1,000 partnership basis plus a $200 special basis adjustment P would have had under section 743(b)) and the basis of his partnership interest would be reduced by that amount. Assume, on the other hand, that one of the assets on hand at the time of the distribution is a capital asset to which a special basis adjustment would not have been made if section 743(b) had been applicable. If P relinquishes his interest in the three parcels of land, the *Regulations* provide that he may make an adjustment in the amount of $200 to the basis of the other capital asset upon receipt of it by distribution.

2. Appreciated Assets — Liquidating Distribution

The primary advantage of section 732(d) in this situation appears to be that of preventing the distributee's basis in the distributed property from shifting away from assets that will produce ordinary gain upon their sale, or shifting from depreciable assets to nondepreciable assets. The problem sought to be overcome by section 732(d) is created by the allocation rules contained in section 732(c) and in *Regulations* pertaining to it. In allocating the partnership interest basis to distributed property, the general rule is that the partnership basis for inventory carries over to the distributee and that the remaining partnership interest basis, after allocation to unrealized receivables and inventory, is allocated to the remaining

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105 INT. REV. CODE of 1954, § 732(a)(1).

106 *Id.* § 732(a)(2).

distributed assets "in proportion to the bases of such other properties in the hands of the partnership before distribution."[107] To illustrate, assume that A purchases W's one-fourth interest in the WXYZ partnership. The partnership assets, liabilities, and capital at the date of the transfer are:

Assets	Adjusted Basis	Market Value
Cash	$ 20,000	$ 20,000
Inventory	48,000	52,000
Buildings (net of straight line depreciation)	24,000	28,000
Land — 4 equal parcels	40,000	40,000
Total Assets	$132,000	$140,000
Liabilities & Capital		
Liabilities	$ 0	$ 0
Capital — W	33,000	35,000
— X	33,000	35,000
— Y	33,000	35,000
— Z	33,000	35,000
Total Liabilities & Capital	$132,000	$140,000

It should be noted that no section 751 assets are present here. A pays W $35,000 for his partnership interest and section 743(a) is applicable so that no adjustment to the basis of partnership assets is made. A has, however, paid W $2,000 for property appreciation in excess of its adjusted basis. A's interest is liquidated by the distribution of $5,000 in cash, one-fourth of the inventory, one building, and one parcel of land. If the general allocation rule is applied, the $30,000 partnership interest ($35,000 less $5,000 cash received) would be allocated to the distributed property in the following manner: $12,000 to inventory, $6,750 to the building ([6,000/16,000 x 18,000])[108] and $11,250 to land ([10,000/16,000] x 18,000). Thus, the appreciation of $1,000 in inventory (¼ of the market value minus ¼ of the adjusted basis) included in A's basis for his partnership interest, has shifted from property that produces ordinary gain on disposition to property that would produce

[107] Treas. Reg. § 1.732-1(c)(1) (1956).

[108] The $18,000 figure is the basis of the partnership interest after reduction for $5,000 cash received and allocation of $12,000 to inventory.

capital gain treatment. If A then sold the inventory at its market value, he will incur ordinary income of $1,000. There is, likewise, a shift from property subject to depreciation to nondepreciable property.

If section 732(d) is applied, the special basis adjustments that A would have had if section 743(b) applied, may be used to correct the results reached under the general rule for allocation. Therefore, the adjusted bases to A of the distributed assets are: $13,000 to inventory ($12,000 partnership basis plus a special basis adjustment of $1,000), $7,000 to building [([6,000/16,000] x 16,000) [109] plus a special basis adjustment of $1,000], and $10,000 to land ([10,000/16,000] x 16,000).

3. Diminished-Value Assets — Current Distribution

Upon the current distribution of an asset to which, if it had been applicable, section 743(b) would require a reduction of the proportionate share of the adjusted basis of partnership property attributable to the transferee, there appears to be no reason for an income tax conscious partner to make an election to apply section 732(d). If the property distributed is depreciable, application of section 732(d) would lower the amount of depreciation the distributee could properly take. If the property distributed is sold by the distributee and section 732(d) had been applied, the loss which was "built-in" the property would be nullified.

4. Diminished-Value Assets — Liquidating Distribution

As with a current distribution of such property, it is also true that an election by the distributee to employ section 732(d) would have adverse consequences for the taxpayer under the statutory scheme as it now stands. To illustrate, the assets, liabilities, and capital accounts of the QRST partnership are:

Assets	Adjusted Basis	Market Value
Cash	$ 20,000	$ 20,000
Inventory	48,000	40,000
Buildings (4 at equal amounts and net of straight line depreciation)	20,000	16,000
Land (4 equal parcels)	40,000	40,000
Total Assets	$128,000	$116,000

[109] The $15,000 figure is the basis of the partnership interest after reduction for $5,000 cash received, removal of the total special adjustment of $3,000, and allocation of $12,000 to inventory.

Liabilities & Capital	*Adjusted Basis*	*Market Value*
Liabilities	$ 0	$ 0
Capital — Q	32,000	29,000
— R	32,000	29,000
— S	32,000	29,000
— T	32,000	29,000
Total Liabilities & Capital	$128,000	$116,000

Q sells his partnership interest to V for $29,000. V's partnership interest is liquidated by the distribution of one-fourth of the cash and inventory, one building, and one parcel of land. Under the general rule for allocation of the partnership interest basis to distributed assets, the partnership interest basis of $24,000 (after reduction for $5,000 cash received) would be allocated as follows: $12,000 (the basis to the partnership carried over to the distributee) to inventory, $4,000 to the building ([5,000/15,000] x 12,000) and $8,000 to the land ([5,000/15,000] x 12,000). In this situation, the general allocation rule has the effect of shifting the negative special basis adjustments which would have been made if section 743(b) had applied up the scale of preferred types of tax-loss property. Thus, a sale of the inventory at its market value would produce an ordinary loss of $2,000.

If the distributee elected to have section 732(d) apply, the special basis adjustments would result in the following bases of property (other than the money distributed) in the hands of the distributee: $10,000 for inventory, $4,000 for the building and $10,000 for the land. Therefore, a sale of the inventory produces neither gain nor loss.

The lesson learned from *Dupree v. United States*[110] suggests one qualification to the desirability of foregoing the section 732(d) election in this situation. That is, of course, that death of the distributee will result in a revaluation of the distributed assets which were not sold or exchanged prior to death. Otherwise, neither the *Code* nor the *Regulation* provide for a result different from the one suggested here.

If the partnership in which an interest is acquired has both property that has increased in value over its adjusted basis to the partnership and property that has declined in value to a level below the partnership adjusted basis, the application of section 732(d)

[110] 391 F.2d 753 (5th Cir. 1968); *see* p. 000, *supra*.

must be preceded by permission to use a desired method granted by the district director.[111]

A matter of significant concern, which has not as yet been considered, is the availability of section 732(d). The time limitation imposed as a condition to its applicability is relatively brief — two years. In the case of a profitable partnership where the whole is equal to more than the constituent parts, the transferee partner may be reluctant to push the idea of a distribution to the point of jeopardizing the firm's continuity. On the other hand, the circumstances may warrant demanding the distribution even to the point of forcing dissolution.[112] In addition, the nature of partnership assets may militate against a distribution. Finally, it seems more than likely that negotiation by the partnership for the sale of assets to which section 732(d) would apply, followed by a distribution to the transferee and completion of the prearranged sale by the transferee, would be recast as a sale by the partnership and a denial of the applicability of section 732(d) to the transferee.[113]

B. Adjustment Required by the Secretary

Section 732(d) must be applied to a distribution, regardless of when made, "if at the time of the transfer [of the partnership interest] the fair market value of the partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership."[114] The *Regulations* add the further condition that section 732(d) must be applied to a liquidating distribution of property to which section 743(b), had it been applicable at the acquisition of the transferee's partnership interest, would have given rise to a special basis adjustment, if the allocation of basis to distributed property rules of section 732(c) "would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance . . . ."[115] Apparently, the Commissioner has interpreted the *Code* provision as having no application to current distributions.

The situation sought to be corrected is demonstrated in detail in the *Regulations*[116] and may be summarized as follows. If the adjusted basis of property not subject to depreciation, depletion, or amortization is below the market value of such property (as reflected in the transferee's partnership interest basis) and the

111 Treas. Reg. § 1.755-1(a)(2) (1956).
112 UNIFORM PARTNERSHIP ACT §§ 31, 32 (1914).
113 *Cf.* Commissioner v. Court Holding Co., 324 U.S. 331 (1945).
114 INT. REV. CODE of 1954, § 732(d).
115 Treas. Reg. § 1.732-1(d)(4)(ii) (1956).
116 *Id.* at example 1.

adjusted basis of depreciable property equals or exceeds the market value of the depreciable property (as reflected in the transferee's partnership interest basis), the application of the general rule for the allocation of partnership interest basis to distributed property of both depreciable and nondepreciable property will result in a shift in basis from the latter to the former and give the transferee a higher amount of depreciation than the realities of his purchase price would warrant.

It will be recalled that in section II A *infra*, an example was given under the heading "Appreciated Value — Liquidating Distributions." That example demonstrated that the transferee may elect, under certain circumstances, to apply section 732(d) to prevent the shift of basis from inventory and depreciable assets to nondepreciable assets. The application of section 732(d) on a mandatory basis is designed to prevent the converse from happening where the transferee's partnership interest basis (or purchase price) will not justify a shift in basis.

III. BASIS ASPECTS OF DISTRIBUTIONS

A distribution of money or property by a partnership to a partner creates basis considerations in respect to three different types of property. A distribution will require the determination of: (1) the basis of the distributed property to the distributee, (2) the basis of the distributee-partner's partnership interest after the distribution, and (3) the basis of remaining partnership assets as they exist after the distribution. This wide range of effects justifies a careful analysis of partnership distributions in the contexts in which they occur.

The successful tax planning of partnership distributions requires that the tax planner have accurate information on the bases of the partners' interests in the partnership as well as the partnership's bases for partnership property. The distinction previously made between the capital accounts of the partners as reflected in the partnership accounting records and the income tax bases of the partners' interests[117] is important and should be reiterated. The values assigned to property contributed by the partners to the partnership for capital account purposes are the result of the partnership agreement. On the other hand, the *Internal Revenue Code* of 1954 provides that the basis of the partner's interest in the partnership "acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of

[117] *See* p. 356, *supra*.

the contribution."[118] The partners may also agree upon the value of property distributed to a partner and the capital account of the distributee will be reduced by the agreed amount; however, in the absence of a proper election and a particular set of circumstances described in the *Code*, the income tax basis of the distributed property or of the distributee's partnership interest governs. Confusion of partnership accounting methods with income tax methods may lead to disastrous income tax consequences.

The discussion that follows will first seek to define distribution for purposes of determining what types of transfers to partners receive treatment as distributions under the provisions of sections 731-36 of the *Code* and what types of transfers are not treated as distributions. Once the definition has been made, the basis provisions of the *Code* as they affect distributor and distributee will be examined.

A. Distributions

A distribution is the actual or constructive transfer of money or property by a partnership to a partner in his capacity as a partner and without any resulting obligation on the recipient. Thus, a loan to a partner is not a distribution.[119] Payment for services performed by the partner for the partnership and payment by the partnership for its use of capital contributed by the partner are not distributions unless the amount of such payments is determined with regard to partnership income.[120] Therefore, the payment of a salary to a partner in an amount which is not contingent upon, or measured by, partnership income reduces partnership taxable income and is reported as ordinary income by the recipient.[121] Provision for such payments in the partnership agreement should insure the desired treatment.

There are three types of transfers which satisfy the definitional requirements of a distribution but which are accorded different treatment by the *Internal Revenue Code*. Two of these exceptions are designed to prevent the employment of the partnership form as a vehicle for tax avoidance.

The first exception has been termed a disproportionate distribution of assets.[122] The *Code* and *Regulations* require that sale or

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[118] INT. REV. CODE of 1954, § 722.

[119] Treas. Reg. § 1.707-1(a) (1958).

[120] INT. REV. CODE of 1954, § 707(c).

[121] Treas. Reg. § 1.707-1(c) (1958).

[122] *See* Alexander, *Collapsible Partnership*, N.Y.U. 19th INST. ON FED. TAX. 257 (1961), Costello, *Problems Under Section 751 Upon Current and Liquidating Distributions and Sales of Partnership Interests*, N.Y.U. 15th INST. ON FED. TAX. 131 (1957).

exchange treatment be given to a disproportionate distribution if (1) the transfer is in partial or complete liquidation of the distributee's partnership interest;[123] (2) the distributed assets were not originally contributed to the partnership by the distributee;[124] (3) the transfer would not otherwise be considered a distributive share or guaranteed payment under section 736(a);[125] and (4) the distributive receives more or less than his proportionate share of the partnership's unrealized receivables or inventory items which have substantially appreciated in value.[126] The effect of a transfer being categorized as a disproportionate distribution is a constructive exchange of assets which were transferred, for assets which were not transferred, to the distributee.[127]

The second type of transaction which may be denied treatment as a distribution occurs when the transfer of property by a partnership to a partner is one step in a plan to effecuate an exchange of property among the partners. The criteria for determining whether exchange treatment will be imposed is the occurrence of contributions and distributions made "within a short period" of each other.[128] Unless the facts of a particular case could lead *only* to the conclusion that the sole purpose of the contribution-distribution pattern was to effectuate the exchange, the exchange concept set forth in the *Regulations* should not be applied because it is in contradiction to the statutory position allowing tax-free contribution of property to a partnership and providing for separate and distinct treatment of distributions. Imposition of *exchange* treatment, when sound business reasons or the operation

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[123] Treas. Reg. § 1.751-1(b)(1)(i) (1965).

[124] INT. REV. CODE of 1954, § 751(b)(2)(A).

[125] *Id.* § 751(b)(2)(B).

[126] *Id.* § 751(b)(1). For the definitions of unrealized receivables, substantial appreciation, and inventory items *see* notes 19 and 20 *supra.*

[127] *See* the detailed analysis in Alexander, *Collapsible Partnerships, N.Y.U.* 19th INST. ON FED. TAX. 247 (1957). The author's discussion suggests that the basis aspects should be considered in two categories. First, in respect to the assets received by the partner which are subject to section 751(b) sale or exchange treatment; the following basis determinations result: the assets which were constructively exchanged receive a cost basis in the distributee's and partnership's hands determined by the values both parties are considered to have paid in the exchange. The distributee's partnership interest basis is reduced by his *proportionate* share of section 751 assets or other assets which were constructively distributed to him and then exchanged with the partnership for the assets actually received by him. Second, if additional assets were distributed and not subject to the operation of section 751(b), the general rules of sections 731-36, discussed in the text *supra,* apply.

[128] Treas. Reg. § 1.731-1(c)(3) (1956). The facts contained in Rev. Rul. 200, 1957-1 CUM. BULL. 205 prompted the Commissioner to require exchange treatment where the distributions to the partners occurred "immediately after" the contributions. A and B, members of the AB partnership, each owned ½ of the stock of X Corporation and Y Corporation. A and B contributed the stocks to the partnership, the partnership was liquidated, A received all of the stock of X Corporation and B received all of the stock of Y Corporation.

of local law require termination of the partnership (resulting in a division of the contributed partnership property), would do violence to the statutory policy.

The prerequisite to treatment of a transfer of property to a partner as a distribution, depends upon the agreement of the partners. When payments are made by a partnership to a retiring partner or to the successor in interest of a deceased partner in liquidation of his partnership interest, section 736 provides that the payment or payments may represent several items. Payments for the partner's interest in the partnership are treated as distributions[129] and are subject to the general rules for determining gain or loss and basis. However, to the extent that substantially appreciated inventory items constitute partnership assets, the sale or exchange treatment required by section 751(b) applies to a disproportionate distribution as discussed *supra*.[130] Distribution treatment also applies to payment for a reasonable amount of goodwill if specifically provided for in the partnership agreement.[131] Otherwise, payment for unspecified goodwill constitutes a payment under section 736(a).[132] To the extent that the payment by the partnership is not for the retiring or deceased's partnership interest, section 736(a) requires classification of the payment as a distributive share or a guaranteed payment rather than as a distribution. This classification results in reduced partnership income for the continuing partners and ordinary income to the recipient.[133] Payment for unrealized receivables are considered section 736(a) payments.

The *Internal Revenue Code* recognizes, and the *Regulations* provide, definitions of two kinds of distributions. A *liquidating* distribution[134] is a distribution which liquidates the distributee's *entire* interest; a *current* distribution[135] is any distribution other than one which liquidates a partner's entire interest. The classification of distributions as current or liquidating encompasses a large variety of business purposes. The income tax term "current distribution" includes the distribution of partnership income to one or more of the partners,[136] payment by the partnership of its

[129] INT. REV. CODE of 1954, § 736(b)(1).

[130] *Id.* § 736(b)(2).

[131] *Id.* § 736(b)(2)(B); *see* Swihart, *Tax Problems Raised by Liquidations of Partnership Interests*, 44 TEX. L. REV. 1209, 1241-50 (1966).

[132] INT. REV. CODE of 1954, § 736(a).

[133] *Id.;* Treas. Reg. § 1.736-1(a)(4) (1965).

[134] INT. REV. CODE of 1954, § 761(d); Treas. Reg. § 1.761-1(d) (1956).

[135] INT. REV. CODE of 1954, §§ 731, 732; Treas. Reg. § 1.731-1(a)(1)(i) (1956).

[136] Treas. Reg. § 1.707-1(c) (1958).

liabilities,[137] contribution to the partnership of property subject to a liability,[138] and a *partial* liquidation of the interest of one or all the partners.[139] A partner's drawings against his distributive share of partnership income during the partnership year is treated as a current distribution made on the last day of the partnership's tax year.[140]

Examples of liquidating distributions include: (1) a distribution to all the partners upon the termination of the partnership under federal income tax law,[141] and (2) that portion of a payment made to a retiring partner which is in exchange for his partnership interest.

B. *Basis of Distributed Property*

As is frequently the case, the *Code* provides both a general approach and an alternative approach to the determination of the basis of distributed property in the hands of the distributee. The alternative provided by section 732(d) has already been discussed[142] and was shown to have only limited applicability. Section 732(d) provides for the adjustment of the basis of distributed property (other than money) at the election of a partner whose partnership interest was acquired by transfer within two years of the date of distribution. Therefore, if the distributee is not a transferee of a partnership interest, or if the distributee is a transferee but acquired his interest more than two years before the distribution, or if the distribution consists entirely of cash, the general basis rules of section 732 apply.

Before considering the basis aspects of a distribution as it affects the distributee, it is important to keep in mind the gain or loss recognition potential of a distribution. The *Code* provides for recognition in the following cases: (1) a current or liquidating distribution of money will produce a capital gain if the amount

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[137] *Id.* § 1.752-1(b)(1) (1956). This is the necessary companion rule to the provision of the *Code* which treats the incurring of, or the increase in, partnership liabilities as a contribution by the partners of money to the partnership. Therefore, liabilities of the partnership add to the basis of the partners' interests in the partnership and payment thereof reduces that basis.

[138] *Id.* § 1.752-1(c) (1956). The portion of the liability attributable to the other partners, whether expressly assumed or not, is treated as a distribution to the contributing partner.

[139] *Id.* § 1.761-1(d) (1956).

[140] *Id.* § 1.731-1(a)(1)(ii) (1956).

[141] A partnership terminates as a result of the complete liquidation of all partners' interest if "no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership . . . ." INT. REV. CODE of 1954, § 708(b)(1)(A). For the effect of the liquidation of one partner's interest in a two-man partnership, *see* Rev. Rul. 65, 1967-1 CUM. BULL. 168; Rev. Rul. 325, 1966-2 CUM. BULL. 249.

[142] *See* section II *supra.*

of money distributed exceeds the distributee's partnership interest basis before the distribution; (2) a liquidating distribution which consists solely of money, unrealized receivables, or inventory items will produce a capital loss when the distributee's partnership interest basis, before the distribution, exceeds the money distributed plus the basis of the unrealized receivables and inventory items to the partnership.[143] The holding period of the partnership interest determines the nature of the capital gain or loss. A current or liquidating distribution of property, including unrealized receivables and inventory items, will not result in the recognition of capital gain regardless of the difference between the fair market value and the distributee's partnership interest basis.[144]

When property is distributed in a current distribution, the basis of the property to the partnership carries over to the distributee and becomes his basis.[145] The basis of the partnership interest of the distributee is reduced by the basis of the property distributed.[146] If the partnership's basis of the distributed property exceeds the distributee's partnership interest basis before the distribution, the basis of the distributed property is limited to the amount of his partnership interest basis;[147] and, as a result, the distributee's partnership interest basis is reduced to zero. Therefore, while the partners would normally give effect to the fair market value of the property distributed in their negotiations, any difference between fair market value and income tax basis will not be recognized until subsequent disposition by the distributee.

Regardless of whether the distribution of cash is current or liquidating, the fundamental income tax rule that the basis of money is the amount thereof applies to such distributions. When money and property are distributed simultaneously, the distributee's partnership interest basis is reduced by the amount of money prior to assigning basis to the distributed property.[148]

In a liquidating distribution of property (or of property and money where the amount of money does not exceed the distributee's partnership interest basis), the *Code* provides for the substitution of the basis of the liquidated partnership interest for the basis of the distributed property.[149] However, the draftsmen retained the

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143 INT. REV. CODE of 1954, § 731.
144 *Id.* § 731(a)(1).
145 *Id.* § 732(a)(1).
146 *Id.* § 733.
147 *Id.* § 732(a)(2).
148 *Id.* § 732(a)(2)(b).
149 *Id.* § 732(b).

use of the partnership's basis for the distributed property for purposes of allocating the substituted basis to the separate properties distributed. Therefore, the liquidated partnership interest basis is allocated first to unrealized receivables and inventory items as defined by section 751(c) and (d) in an amount equal to the basis of those assets to the partnership, and the balance of the partnership interest basis is allocated to other distributed properties in proportion to their adjusted basis to the partnership.[150]

A liquidating distribution of property will postpone the recognition of gain or loss until subsequent distribution by the distributee. Predictably, the partnership provision for non-recognition of gain or loss on distributions of property have been held to take precedence over the *Code's* loss recognition provision contained in section 165.[151] For example, the liquidating distribution of a mortgage with a face amount which is less than the distributee's partnership interest basis reflects a "built-in" loss which will not be recognized until subsequent collection or disposition, and which will disappear if the distributee dies before collection and without disposing of the note.[152]

When the distributee has a special basis adjustment resulting from the prior application of sections 734(b) and 743(b), the special basis adjustment is given effect in computing the basis of the distributed property. For example, if a transferee receives a distribution of property and relinquishes his right to property which is subject to a special basis adjustment with respect to him, the special basis adjustment will be applied to the property distributed to him if the relinquished and distributed properties are of like kind.[153]

C. *Basis of Undistributed Partnership Property*

The general rule governing the basis of undistributed partnership property is that the distribution does not give rise to an adjustment.[154] The partnership's basis of its assets is, of course, reduced by the basis to the partnership of those assets which it no longer owns as a result of the distribution; but the general rule prohibits an adjustment to reflect recognized gain or loss by the distributee or a change in the amount of basis attributed to property other than money when a property distribution occurs.

[150] *Id.* § 732(c).

[151] Dupree v. United States, 391 F.2d 753 (5th Cir. 1968).

[152] *Id.*

[153] Treas. Reg. § 1.743-1(b)(2)(ii) (1956).

[154] INT. REV. CODE of 1954, § 734(a).

Therefore, when money is distributed in a current or liquidating distribution, in an amount which exceeds the distributee's partnership interest basis, or when assets consisting solely of money, unrealized receivables, and inventory items having a basis to the partnership which is less than the distributee's partnership interest basis are distributed in a liquidating distribution, gain and loss, respectively, are recognized, but the gain or loss does not affect the basis of remaining partnership assets. Similarly, in a current or liquidating distribution, when property other than money takes a lower basis in the distributee's hands than the property's basis to the partnership, or when a liquidating distribution of property results in an increment to the basis of the distributed property in the distributee's hands, the resulting diminution and increment, respectively, to the basis of the distributed property does not affect the basis of remaining partnership assets.

The *Code* provides an alternative approach in section 734(b) in the form of an optional adjustment to the basis of undistributed property. The effect of this provision is, as stated by a leading authority on the subject,

> that the partnership's adjusted basis of its undistributed property shall be:
>
> 1. *Increased* in the amount of *taxable gain* recognized to the distributee.
> 2. *Decreased* in the amount of *deductible loss* recognized to the distributee.
> 3. *Increased in the amount* of the *decrease in basis* of the distributed property when it is passed from the partnership to the partner.
> 4. *Decreased* in the amount of the *increase in basis* of the distributed property when it passes from the partnership to the partner.[155]

It will be recalled that the optional adjustment to basis as applied in the case of a transfer of a partnership interest gave effect to the purchase price, or the fair market value, of the underlying assets. As applied to distributions, the optional adjustment to the basis of undistributed partnership assets has the same effect in the case of a liquidating cash distribution. In the case of property distributions, however, the optional adjustment relates only to the changes which occur in the adjusted basis of the distributed property as a result of the rules for determining the basis of distributed property.

The optional adjustment is most frequently encountered when a liquidation of one of the partner's interests occurs. To illustrate,

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[155] A. WILLIS, HANDBOOK ON PARTNERSHIP TAXATION 339 (1957) [hereinafter cited as WILLIS].

the MNOP partnership has the following assets, liabilities, and capital:

Assets	Adjusted Basis	Market Value
Cash	$ 8,000	$ 8,000
Accounts Receivable	2,000	2,000
Inventory	8,000	8,000
Land	2,000	6,000
Total Assets	$20,000	$24,000
Liabilities and Capital		
Liabilities	-0-	-0-
Capital Accounts — M	$ 5,000	$ 6,000
— N	5,000	6,000
— O	5,000	6,000
— P	5,000	6,000
	$20,000	$24,000

Assume the partners agree to retire M's interest and that the liquidating distribution shall be made in exchange for it. The agreement of the partners meets the requirements of section 736(b) and thus, distribution treatment is proper. Next, it is important to note that the exception to section 736(b) for disproportionate distributions does not apply since none of the "inventory items" on the balance sheet are substantially appreciated in value.[156]

If M receives a $6,000 cash payment in liquidation of his interest, M recognizes a capital gain of $1,000 as a result of section 731 (a). If the partnership elects to adjust its basis under section 734(b), it may increase the basis of remaining assets by $1,000.[157] A close correlation exists between the adjustment under section 743(b) for the transferee of a partnership interest and the cash liquidation. The cash liquidation represents, in effect, the transfer of the interest to the partnership.

If instead, M receives the land with a market value of $6,000 in liquidation of his interest, M recognizes no gain or loss under section 731. If the distribution is subject to the special basis adjustment rule of section 734, a negative special basis adjustment, measured by the amount of the increase in basis of the distributed

[156] The *Code* as interpreted by the Commissioner, requires that the fair market value of all the inventory items be added and then compared with the sum of the adjusted basis of the inventory items. Accounts receivable are inventory items. Treas. Reg. § 1.751-1(d)(2)(ii) (1965).

[157] INT. REV. CODE of 1954, § 734(b).

property when it passes from the partnership to the partner, arises.[158] Therefore, the special basis adjustment is a minus $3,000 (the difference between the basis of the land in the distributee's hands under section 732(b), or $5,000, and the basis of the land to the partnership, or $2,000).

If, instead, M receives three-fourths of the inventory, or a fair market value of $6,000, and section 734(b) is applicable, an increasing special basis adjustment, measured by the decrease in basis of the distributed property when it passes from the partnership to the partner, arises.[159] The special basis adjustment would be $1,000 (basis of three-fourths of the accounts receivable to the partnership, or $6,000, less the basis of the receivables in M's hands under section 732(b), or $5,000).

In both examples of property distributions it is important to realize that the fair market value of the retiring partner's interest in the partnership and the fair market value of the property distributed in retirement of that interest, while of importance in the negotiations between the retiring partner and the remaining partners, play no part in the section 734(b) special basis adjustment. Section 734(b) embodies the aggregate approach to partnerships as applied to liquidating distributions. With respect to property, the adjustment has the effect of applying the principle that in a nontaxable exchange of property, the basis of the property exchanged becomes the basis of the property acquired.[160] Thus, in the distribution of the land, section 734(b) treats the remaining partners as having exchanged their share of the land with a basis of $1,500 (three-fourths of $2,000) for the retiring partner's one-fourth share of the basis of undistributed partnership properties, or $4,500 (one-fourth of $8,000 cash, $2,000 accounts receivable, and $8,000 inventory). In the absence of section 734(b), the basis of the remaining assets is $18,000 ($20,000 total basis minus partnership basis for land of $2,000). Applying the nontaxable exchange rationale, the remaining partners' proportionate share of the partnership assets not distributed ($13,500 — three-fourths of the cash, accounts receivable, and inventory) is added to the remaining partners' basis for the property exchanged which, as previously determined, was $1,500. The difference between the unadjusted basis of $18,000 and the $15,000 basis computed under the aggregate exchange approach is the same amount that the statutory computation of section 734(b) produces.

Current distributions of money and current distributions of property, where there is a decrease in the basis of the property, are

158 *Id.* § 734(b)(2)(B).
159 *Id.* § 734(b)(1)(B).
160 WILLIS, *supra* note 155, at 338.

also subject to the special basis adjustment provision if the election to make the provision applicable has been made.[161] The rationale in the case of liquidating distributions cannot be applied to current distributions since such distributions do not embody the concept of an exchange. The possibility of a current distribution being subject to the provision of section 734(b) are more prevalent than might be expected. A current distribution to a partner who contributes property with a low basis and a high fair market value may well require an adjustment.[162] The contribution of property subject to a liability in excess of its adjusted basis could result in section 734(b) treatment if the amount of the liability assumed by the noncontributing partners exceeds the adjusted basis of the contributed property.[163] A decreasing special basis adjustment upon the distribution of property is only possible where the distribution liquidates the entire interest of the distributee.[164] A current distribution of property will not result in a decreasing special basis adjustment.

As in the case of a transfer of a partnership interest, the special basis adjustment is allocated to the partnership properties under rules provided by section 755[165] and will affect: (1) the subsequent recognition of gain or loss by the partnership upon disposition of properties subject to the special basis adjustment, (2) depreciation on such properties, and (3) basis if the properties are subsequently distributed. A special basis adjustment that increases the basis of partnership properties is generally desirable to the remaining partners, whereas a decreasing special basis adjustment is generally undesirable. The special basis adjustment is more troublesome in its applicability to distributions. When applied to transfers of a partnership interest, the nature of the special basis adjustment is readily apparent from a comparison of the transferee's basis and the adjusted basis of the assets of the partnership. With distributions, the comparison required is that of the distributee's partnership interest basis and the partnership's basis of the property to be distributed. It is therefore possible to have an overall appreciation in the value of partnership assets above their adjusted basis, but nevertheless to have a special basis adjustment which decreases the basis of remaining assets. In the MNOP partnership example *supra,* the adjusted basis of partnership assets was $20,000 and their fair

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[161] INT. REV. CODE of 1954, § 734(b)(1)(A); *id.* § 734(b)(1)(B).

[162] Milroy, *Tax Aspects of Partnership Distributions and Transfers of Partnership Interests,* 41 IND. L.J. 636 (1966).

[163] Treas. Reg. § 1.752-1(c) (1956).

[164] INT. REV. CODE of 1954, § 734(b)(2)(B). Section 734(b)(2)(B) applies only to distributions "to which section 732(b) applies" —*i.e.* distributions in liquidation.

[165] *See* section IV,A *infra.*

market value was $24,000. The distribution of inventory produced an increasing special basis adjustment, but the distribution of land would result in a decreasing special basis adjustment. This demonstrates the need for careful selection of the property to be distributed to avoid unwanted results when section 734(b) is applicable.

IV. Allocation of the Special Basis Adjustment and the Shifting Special Basis Adjustment

In the foregoing discussion, a number of assumptions were made about the nature of the special basis adjustment for purposes of illustration and clarity. The assumptions were: (1) the partnership owned classes of assets which had all appreciated in value when compared with their respective adjusted bases or which all had declined in value to amounts less than their adjusted bases, (2) the classes of assets represented either one particular item of property or a number of items of property all of which had increased or decreased in value as compared with their respective adjusted partnership bases, (3) the transferee's partnership interest basis did not reflect payment for goodwill or going concern value of the business enterprise, and (4) the property to which the special basis adjustment attaches either remained a partnership asset or was distributed to the transferee. Each of these assumptions, while justified for the purposes made therein, do not comport with the realities of the circumstances in which a transfer or distribution subject to section 743(b) is made. Therefore, it is the purpose of this section to examine the operation of the 1954 *Code* with respect to the actualities of the usual type of transfer of a partnership interest and distribution of property to a transferee of that interest.

A. *Allocation of Basis*

Subchapter K of the 1954 *Code* contains rules for the allocation to partnership assets of a special basis adjustment occasioned by a transfer to which section 743(b), and a distribution to which section 734(b), are applicable.[166] In transfers and liquidating distributions of cash, the special basis adjustment is presumably a reflection of changes in the values of partnership properties when such values are compared with the adjusted bases of the properties to the partnership.[167] The special basis adjustment may be attribut-

[166] INT. REV. CODE of 1954, § 755.

[167] It has been accurately pointed out that a special basis adjustment may arise absent consideration of the value of the partnership property. For example, "a dissident partner who is threatening legal action" may receive an excessive payment for his interest in exchange for his partnership interest with the sole purpose of the remaining partners being to exclude him from the partnership. In certain circumstances, the excessive payment would not represent goodwill or going concern value. WILLIS, *supra* note 155, at 245.

able to tangible and intangible partnership property, including goodwill.

A basic feature of the allocation section is its reliance on fair market value as one of the factors employed to make the allocation. A question of significant importance is the role of the negotiating parties to a transfer or a distribution in the determination of fair market value. Unlike other partnership provisions,[168] neither the *Code* nor the *Regulations* mention the agreement between the parties in the allocation provision. It does not seem, however, that omission of a reference to the agreement between the buyer and seller, or the partners and the distributee, should prejudice market values established by it so long as they are reasonable. Section 751, dealing with the sale or exchange of an interest in a partnership which has unrealized receivables or inventory which has substantially increased in value, has been construed by the *Regulations* to give effect to the reasonable values contained in an agreement between the parties.[169] Considering the relative similarity between section 751 and sections 741-43 (to which the allocation section may be applicable), a good reason does not appear for according differing treatments to the values established by negotiations, subject, of course, to the requirement of reasonableness.

The application of the allocation provisions of section 755 requires four steps in a transfer. The first step requires the segregation of the partnership property into two classes. Capital assets[170] and property used in a trade or business[171] are combined into one class and all other partnership assets constitute the other class.[172] The next step is to determine the proportionate share of the special basis adjustment that is attributable to each of the two classes. This is accomplished by comparing the fair market value of each asset in the class with its adjusted basis to the partnerhip and adding the individual increases and decreases together to determine the net increase or decrease for each class. Third, the special basis adjustment is then allocated to each class in an amount representing the proportion of that class' increase or decrease to the total increase or decrease.[173] The fourth step is to allocate the special basis adjustment attributable to the assets within the class "in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of

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[168] *See* Treas. Reg. § 1.751-1(a)(2) (1965).

[169] *Id.* § 1.751-1(c)(ii)(3) (1965).

[170] INT. REV. CODE of 1954, § 1221.

[171] *Id.* § 1231(b).

[172] *Id.* § 755(b).

[173] Treas. Reg. § 1.755-1(c) (example 3) (1956).

partnership properties . . . ."[174] Presumably, this would be done by allocating the special basis adjustment attributable to the class: (1) in the case where the special basis adjustment to the class is an addition to the adjusted basis of the partnership assets, to each asset in the proportion of its increase in fair market value over its partnership adjusted basis to the total increases within the class, without reference to any decreases attributable to assets in the class, and (2) in the case where the special basis adjustment to the class results in a decrease in the adjusted basis of the partnership assets, to each asset in the proportion of its decrease in fair market value below its partnership adjusted basis to the total decreases within the class, without regard to any increases attributable to assets in the class.

In the event of a distribution of money in liquidation of a partner's interest, the *Regulations* provide that an adjustment to the basis of partnership assets pursuant to section 734(b) "must be allocated only to capital assets or section 1231(b) property [used in a trade or business]."[175] When applied to a liquidating distribution of cash, the position taken in the *Regulations* is wholly untenable. It ignores the realities of circumstances that attend a liquidating distribution. The decision by the partners of the amount to be distributed to the outgoing partner in most cases is based on the market value of the partnership assets. If, for instance, the partnership has inventory that has appreciated in value (but not to the extent that it is substantially appreciated inventory within the scope of section 751), that appreciation is reflected in the amount of the cash distribution. The effect of the *Regulation* is to shift the adjustment to basis from property that will produce ordinary gain upon its sale to capital assets and depreciable property. On the other hand, the allocation of a *minus* basis adjustment, if applied in the manner set forth in the *Regulations*, would shift the basis adjustment from property that would produce an ordinary loss to capital assets or depreciable property. Either way the partnership suffers unwarranted tax consequences because in the former situation, the sale by the partnership of its inventory results in a higher ordinary gain and, in the latter, a justifiable ordinary loss is denied. The statutory language of section 755 does not call for such a result. It seems that the more appropriate means of allocating the adjustment to basis of partnership assets is the method employed upon the transfer of a partnership interest. As it now stands, the method adopted by the *Regulations* may lead to invidious results

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[174] INT. REV. CODE of 1954, § 755(a)(1).

[175] Treas. Reg. § 1.755-1(b)(1)(ii) (1956).

based entirely on the form (by the partners or by the partnership) by which the outgoing partner's interest is purchased. Unlike the effect of other provisions of subchapter K,[176] this is not a matter of the partners determining *inter se* the tax consequences of a transaction, since the present allocation rule has no effect upon the distributee.

Where the transaction that gives rise to the special basis adjustment is a distribution of property, the *Regulations* provide that the special basis adjustment is to be "allocated to remaining partnership property . . . with respect to which the adjustment arose."[177] This method appears to suffer from an infirmity similar to the one just discussed. The character of the property distributed is the basis for classifying the special basis adjustment, rather than the character of the property with respect to which the distributee has relinquished his interest. The method for allocating the special basis adjustment among the properties within the classes would be the same as, in the case of allocation as a result of a transfer, steps 3 and 4 *supra* page 377.

The allocation procedures prescribed by the *Code* and *Regulations* are deficient because of the use of two factors — the classification procedure and the use of net increase or net decrease amounts — at two different levels — the classified group of assets and at the individual asset level. The reasoning behind the allocation procedure appears to be a desire to prevent the procedure from becoming a tax avoidance tool and to achieve simplicity. The one is justifiable, the other, in the opinion of the author, is not.[178]

At the class level, a significant net increase for one class, used for making the allocation, may be partially, or completely, offset by a net decrease in the other class.[179] Since the *Regulations'* procedure does not provide for an increasing allocation to one class and a decreasing allocation to the other class, only the net increase or net decrease is used for allocation purposes. As between the two classes, the result of the method may be to only minimally affect the basis of the net increase class with no change in the net decrease class. To illustrate, assume that the net increases to "all other property" is $4,000 and the net decrease to capital assets and section

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[176] *See* INT. REV. CODE of 1954, § 736 and the text accompanying note 44 *supra.*

[177] Treas. Reg. § 1.755-1(b)(1)(i) (1956).

[178] Little, if anything, contained in subchapter K, other than the effective date provision, is, in fact, simple. Even the effective date provision involved some room for confusion in 1954. *See* Jackson, Johnson, Surrey, Tenen & Warren, *The Internal Revenue Code* of 1954: *Partnerships,* 54 COLUM. L. REV. 1183, 1235 n.100 (1954). In the single-asset partnership, the allocation procedures are no doubt effective. But where the assets are numerous and have varying fair market values and bases, "simplicity" may work inequity.

[179] *See* WILLIS, *supra* note 155, at 242.

1231(b) property is $3,000. The existing allocation method would require the allocation of the special basis adjustment of $1,000 (assuming net increase also represents the difference between the cost of the partnership interest and the transferee's proportionate share of the adjusted basis of partnership property) to "all other assets." But an increased basis in the amount of $1,000 is not a true reflection of the transaction. Rather, an increase of $4,000 to the basis of "all other property" and a decrease of $3,000 in the basis of capital assets and section 1231(b) property would produce an accurate accounting. If "all other assets" are sold, the sale would produce a $4,000 gain allocable to the transferee, in the case of a transfer, or to the partnership, in the case of a distribution, yet only $1,000 of the gain is offset by the allocated special basis adjustment. Capital assets and section 1231(b) property would continue to have an adjusted basis that is $3,000 in excess of its fair market value. This same situation may occur at the individual asset level of the allocation method.

An alternative to the allocation method prescribed by the *Code* and *Regulations* does exist. The *Regulations* provide that the partnership may file an application with the district director for permission to use another method and the district director is permitted to allow increases to the bases of some properties and decreases to others, so long as such increases and decreases reduce the difference between the fair market value and the adjusted basis of the partnership property.[180] Permission to adopt a different method is conditioned upon a "satisfactory showing" of the values used by the parties to the transaction, or in the case of transfer as a result of death, the fair market value at the relevant date. Perhaps the matter of most significance is the deadline for submitting the application. That deadline is 30 days after the close of the partnership year in which the special basis adjustment was created. Therefore, for the first year to which the election under section 755[181] to adjust the basis of partnership assets pursuant to sections 734(b) and 743(b) applies, application to adopt a different method of allocation will precede the election to make the basis adjustments.

The question of whether the special basis adjustment allocable to a single item of partnership property may exceed its fair market value has been answered in the affirmative in *United States v. Cornish*.[182] Relying upon the legislative history, the court concluded

[180] Treas. Reg. § 1.755-1(a)(2) (1956).

[181] The question of when the section 755 election must be filed is discussed in section V *infra*. The *Regulations* provide that the section 755 election must be filed with the partnership income tax return for the first taxable year to which it applies. Treas. Reg. § 1.754-1(b) (1956).

[182] 348 F.2d 175 (9th Cir. 1965).

that the fair market value concept was not intended to establish a limitation but rather to be used for allocation purposes.[183] The statutory phraseology, "reducing the difference" was found to mean "that where there are several classes of depreciable partnership properties, the percentage of difference between the fair market value and the adjusted basis of each shall be maintained in allocating the total amount of the increase in the adjusted basis attributable to depreciable assets."[184] The decision has the effect of nullifying two provisions in the *Regulations* that considered fair market value as a limitation.[185]

The *Regulations* require a portion of the special basis adjustment to "be allocated to partnership good will, to the extent that good will exists and is reflected in the value of the property distributed, the price at which the partnership interest is sold, or the basis of the partnership interest determined under section 1014 . . . ."[186] "Going concern value"[187] has been held to be an intangible partnership asset and the subject of an allocation of a special basis adjustment.[188]

The *Cornish* case, concerned an interesting allocation question. The court found that the purchase price of a partnership interest represented: (1) the fair market value of the tangible partnership assets, (2) "going concern" value as an intangible partnership asset, and (3) an overvaluation of the partnership interest. The purchasing partners had, in effect, paid more for their interests than they were worth. The government argued that the overvaluation must be treated as if it was an intangible partnership property. Instead, the court held that the overvaluation should be prorated between tangible assets and "going concern value" on the rationale, previously mentioned, that the adjusted basis of partnership property after the allocation of the special basis adjustment could exceed the fair market value of the property.

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[183] *Id.* at 186 n.17.

[184] *Id.* at 186. This same problem of overvaluation appears to have been present in the facts of *Victor G. Mushro,* 50 T.C. 43 (1968), where a buy-sell agreement between the partners, funded with life insurance, resulted in the payment to a deceased partner's widow of an amount approximately 1.4 times the fair market value of the interest at his death. However, no suggestion is made in the case that the buying partners had attempted to allocate the overpayment to tangible partnership property.

[185] Treas. Reg. § 1.755-1(a)(ii,iii) (1956).

[186] *Id.* § 1.755-1(a)(iv).

[187] *See* Los Angeles Gas & Elec. Corp. v. Railroad Comm'n., 289 U.S. 287 (1933), wherein the Supreme Court distinguished going concern value and goodwill. Going concern value is present where " 'there is an element of value in an assembled . . . plant, doing business and earning money, over one not thus advanced . . . .' " Goodwill, on the other hand is that " 'element of value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business . . . .' " *Id.* at 313.

[188] United States v. Cornish, 348 F.2d 175, 185 (9th Cir. 1965).

B. *Shifting Basis Adjustments*

The *Code* and *Regulations* contain two curious concepts that may change the income tax consequences of the special basis adjustment. One is the shifting special basis adjustment and the other the special basis adjustment *in nubibus*.[189] The latter may be created by, among other ways, the former.

The special basis adjustment *in nubibus* is the product of a distribution, either current or liquidating, but, logically, not of a transfer of a partnership interest. The special basis adjustment may have existed prior to the distribution, in which case it is the shifting that causes the in abeyance aspect) as is the case of a prior transfer to which section 743(b) applied, or may be created by a distribution. If property is distributed and the partnership does not have like property at the time of the distribution, the special basis adjustment is held in abeyance. The definition of like property, however, appears to vary depending on the distribution. Thus, in the case of property to which a special basis adjustment is allocated for the benefit of a transferee, a distribution of that property to another partner will cause the special basis adjustment to shift away from the distributed property. It will attach to other property of a like kind.[190] For purposes of this particular situation, like property is "property of the same class, that is, stock in trade, property used in a trade or business, capital assets, etc."[191] If property of a like kind is not owned by the partnership, the special basis adjustment is *in nubibus* until it is acquired.

However, in the case of a distribution to which section 734(b) applies, a shift in basis is not involved, and while not entirely free from doubt, it appears that like property is determined by reference to the two classes established in section 755 for the allocation of the special basis adjustment. Under this interpretation, like property is property of the same class, and the two classes are (1) capital assets and section 1231(b) property and (2) all other assets. This reasoning has led one author to conclude that a special basis adjustment *in nubibus* which is created by the distribution of capital assets may be applied to depreciable property, if owned at the time of the distribution or acquired before other capital assets are also

[189] Literally, "in the clouds." The choice of the Latin designation serves the purpose of a loose analogy to the feudal land law policy that title to land may not be in abeyance. *See* A. KALES, ESTATES, FUTURE-INTERESTS, AND ILLEGAL CONDITIONS AND RESTRAINTS IN ILLINOIS 26 (1920). The present author feels that, although the reasons behind the policy for land law purposes and income tax purposes are, quite naturally, very different, the policy against such a situation should be the same in both contexts. A. Willis refers to this same situation as the "Peter Pan" adjustment.

[190] Treas. Reg. § 1.732-2(b) (example) (1956); *Id.* § 1.743-1(b)(2)(ii) (1956).

[191] *Id.* § 1.743-1(b)(2)(ii) (1956).

acquired, since both types of property are of the same class.[192] In the absence of property to which it attaches, depreciation or depletion on an increasing special basis adjustment would not be available.

The foregoing suggests that attention must be directed to the type of property that is intended to be distributed along with consideration of the type of property that will remain in the partnership after distribution.

V. THE ELECTIONS

A. *The Section 754 Election*

As previously mentioned, an adjustment to the basis of partnership assets occasioned by a distribution within section 734(b) or a transfer of a partnership interest within section 743(b) may be made at the option of the partnership, providing the election required by section 754[193] is properly filed. Since the burden of making the election is imposed upon the partnership, section 754 deserves close scrutiny.

The *Code* provides for the filing of an election "in accordance with regulations prescribed by the Secretary or his delegate . . . ."[194] Pursuant to the statutory command, a regulation has been promulgated stating that the "election . . . shall be made in a written statement filed with the partnership return . . . ."[195] In addition to declaring the election, the written statement must also contain the name and address of the partnership and be signed by one of the partners.[196]

The proper date for filing the election in order to make it applicable is a matter on which there exists a conflict of authority. Neither the specific language of section 754, nor the Senate proceedings[197] at the time of adoption of the election provision, contain any indication of when the election must be filed. The pertinent regulation takes the position that the election must be "filed with the partnership return for the first taxable year to which the election applies . . . ."[198] Some degree of hindsight is clearly allowed the partnership since the Internal Revenue Service has confirmed the

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[192] Jordan, *Adjusting the Basis of Partnership Property: When to Elect, How to Determine,* 22 J. TAX. 242 (1965).

[193] INT. REV. CODE of 1954, § 754.

[194] *Id.*

[195] Treas. Reg. § 1.754-1(b) (1956).

[196] *Id.*

[197] S. REP. NO. 1622, 83rd Cong., 2d Sess. 406 (1954).

[198] Treas. Reg. § 1.754-1(b) (1956).

logical conclusion, implicit in the statutory language, that the election need not be filed in anticipation of the election's desired applicability.[199] Nor do the *Regulations* require that the election need be made when the particular transfer or distribution occurs. It therefore seems desirable for the partners to review distributions and any transfers of partnership interests made during the taxable year, along with such other considerations as the effect of the applicability of the election to future distributions and transfers and the apparent difficulty of revoking the election once it has been made, before the partnership return is filed each year. In addition, it seems that a valid election may be made where the partnership has been granted an extension of time for filing its return under section 6081(a) of the 1954 *Code*.[200]

The applicability of an election to a distribution or transfer of a partnership interest made within a taxable year, where the election is not filed within the statutory period for filing the partnership return for that year, is foreclosed by the requirements of the *Regulations*[201] and by a Revenue Ruling. [202] Taxpayers in two cases have sought to avoid these limitations with interesting results. The first test of the validity of the *Regulations* was made in *Neel v. United States*,[203] a district court case. In the *Neel* case, the partnership filed the election approximately two and one-half years after the filing date of its partnership income tax return for the year in which a partnership interest was transferred upon the death of a partner. The deceased partner's estate had, during the period before the partnership filed the election, made an adjustment to the reported distributive share of partnership income to reflect the use of cost depletion. The use of cost depletion by the estate would have been proper only by virtue of an adjustment to the basis of depletable partnership property under section 743(b). The court found the timely filing requirement of the *Regulations* invalid on the grounds that a regulation, in order to be valid, must be reasonable and that "[r]egulation § 1.754-1 adopted by the Commissioner has the effect of imposing a penalty . . . ."[204] The Government did not appeal.

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199 Rev. Rul. 347, 1957-2 CUM. BULL. 365.

200 "Presumably, an election is valid if it meets all the requirements [of Treas. Reg. § 1.754-1(b)], even if the election statement accompanies a Form 1065 which is filed on the last day of the maximum extended return-filing period of six months after the statutory due date of the return." Jordan, *Adjusting the Basis of Partnership Property: When to Elect, How to Determine,* 22 J. TAX. 242 (1965) (footnote omitted).

201 Treas. Reg. § 1.754-1(b) (1956).

202 Rev. Rul. 347, 1959-2 CUM. BULL. 365.

203 266 F. Supp. 7 (N.D. Ga. 1966).

204 *Id.* at 10.

Dupree v. United States,[205] a court of appeals decision subsequent to *Neel*, held adverse to the taxpayer-partner's contention that the partnership election was timely filed. Dupree and his wife owned a community property interest in a limited partnership. Upon the death of his wife in 1957, Dupree received a stepped-up basis for his one-half of the partnership interest pursuant to section 1014(b) (6). In 1960, the principal asset of the limited partnership, a motel, was sold, the partnership was liquidated, and Dupree's proportionate share of the capital gain realized on the sale was reported on the final partnership return, but not on the taxpayer's individual return. The section 754 election was not filed until 1962. The court found that for a valid election to have been made for 1960 (*the year of the sale of the partnership asset*), it should have been filed with the original partnership return for 1960 or with an amended return filed within the statutory time for filing the original return. The court specifically declined to decide the issue presented in the *Neel* case — whether the election could only be made with the partnership return for the year in which the partnership interest was transferred.[206]

These cases are susceptible of two interpretations. It may be said that the *Neel* decision is not impaired by *Dupree* but that the latter case puts a qualification on the position announced in the former case. Thus, it may be argued that the two cases interpreted together, do not require the section 754 election to be made in the partnership return for the year in which a partnership interest is transferred, but the election must be filed with the partnership return for the year in which the partnership asset (or assets) to which the basis adjustment applies is sold or exchanged. However, this interpretation raises more problems than it solves. First, where the partner, in determining his taxable income, adjusts the reported amount of his distributive share of taxable income to reflect the basis adjustment to partnership assets, the partner rather than the partnership has made the election. This is contrary to the requirement of section 754 that the election, because it potentially affects all the partners, is to be made by the partnership. The effect of allowing a partner to make such adjustments would destroy the purpose of the partnership return. One transferee-partner would make adjustments where it would reduce his taxable income, whereas another transferee-partner would not adjust his taxable income to reflect an adjustment that reduces his proportionate share of the basis of partnership assets, because such an adjustment may increase

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[205] F.2d 753 (5th Cir. 1968).

[206] *Id.* at 759.

his taxable income. Moreover, absent the affirmative election initially, there would be no assurance that the partnership would ever make the election.

The second deficiency inherent in this approach is the potential confusion that would result in making the sale or exchange of the partnership asset the transaction that gives rise to the filing requirement. Where the adjustment to basis of partnership assets would result from the transfer of a partnership interest, the adjustment is made to the assets, owned at that time by the partnership, that have appreciated or depreciated in value prior to the transfer of the partnership interest. Where such increase or decrease in value applies to inventory items, the election may be required immediately under this interpretation. Where the increase or decrease applies to investments or fixed assets, it could be years before the election would need to be filed.[207]

Finally, the section 754 election applies to remaining partnership assets after distributions as well as to transfers of partnership interests. The proposed interpretation would allow the partners to determine at the time of the sale of partnership assets, which had appreciated or depreciated in value as of the date of the prior distribution, whether to make the election. The election would become a tool for blatant tax avoidance.

An alternative, and probably more accurate, interpretation of *Neel* and *Dupree* is that *Neel* stands alone in allowing an election to be made after the expiration of the statutory time for filing the partnership return for the year in which the transfer of a partnership interest occurred. It should be noted that the taxpayer's contention in *Dupree* was that the election was in effect for the year of the sale of the partnership asset. The taxpayer did not argue for the application of the election to the date of the transfer of the partnership interest. As a result, the court left the *Neel* issue up in the air.

One clear factor must be considered when it appears desirable for the partnership to make an election attempting to give it retroactive application. The Internal Revenue Service does not agree with the *Neel* decision and can be expected to press their position whenever a taxpayer relies on *Neel.* In *Dupree,* Government council urged the court to overrule the earlier *Neel* holding with no success. It seems doubtful that the issue is, as yet, resolved.

The *Code* provides that "[s]uch an election shall apply with respect to *all* distributions of property by the partnership and to *all* transfers of interests in the partnership during the taxable year

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[207] In this regard, compare the section 732(d) election discussed in section VI B *infra.*

with respect to which such election was filed and *all* subsequent taxable years."[208] For the unwary, this provision may create undesirable tax consequences. The election applies to the whole year for which the election is made, and it may encompass distributions of property and transfers of partnership interests that give rise to desirable and undesirable basis adjustments. To illustrate, partners A, B, C, D, and E each own a 20 percent interest in the profits and assets of the partnership. A's interest is liquidated early in the year by the distribution of partnership property with a basis to the partnership which is less than the distributee's partnership interest basis. Later in the taxable year, B sells his partnership interest to F for an amount in excess of B's proportionate adjusted basis in partnership assets. If, through inadvertence or a failure to read the statute thoroughly, the partnership makes the election for F's benefit, the election will require an adjustment reducing the basis of the proportionate assets of the partnership held by each partner to reflect the effect of the earlier distribution. While there is some advantage to F, the election is disadvantageous to the other partners. If these other partners are aware of the tax consequences of the section 754 election, they would probably refuse to make the election. This would, of course, deny F the full tax benefits of the purchase price of his partnership interest.

The *Code's* choice of the partnership year as the device for determining the applicability of the election to adjust the basis of partnership property may be used as a tax planning device with favorable consequences to present and potential partners. In the example of the ABCDE partnership above, B should refrain from making the sale until after the close of the partnership year. An election filed for the next partnership year would give F a stepped-up basis in his portion of the partnership assets without requiring the partnership to reduce its basis in those assets to reflect the distribution to A in the prior year. There are, of course, other circumstances in which downward basis adjustments may be avoided by completing the particular transactions that would cause such adjustments before the year for which the election is made.

Since the election applies to the partnership, the decision to make the election is a matter for collective determination. The election is a matter of potential controversy since its binding, prospective effect on the partnership may cause the decrease of partnership asset basis which could more than offset any immediate benefits. The partners may also hesitate where it appears that the benefits gained may be nullified by the administrative burden that results

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[208] INT. REV. CODE of 1954, § 754 (emphasis added).

from the extra record keeping. Therefore, the proper time for partner consideration of the subject is in the planning stage. The purchaser of a partnership interest will be well advised to determine the positions of the other partners during prepurchase negotiation and to reduce the matter to writing by a statement in the new partnership agreement to the effect that the partnership elects to have section 754 applied. A liquidated damages clause would give the transferee a good measure of security against a later change in heart by the other partners resulting in a failure to file. The internal declaration, at the outset, of the partners' desire to have section 754 made applicable, has the further advantage of providing some insurance against events which occur prior to the formal filing of the election. Short of effecting a dissolution under state law, an intervening event, *e.g.* the insanity of a partner,[209] would not jeopardize the election since the filing of the election statement is a ministerial act and only requires the signature of one partner.

Although there is a lack of direct authority on this point, a refusal to file the election in violation of an express or implied agreement to do so may be such as to sustain a cause of action for damages.[210]

Section 754 provides for revocation of the election "subject to such limitations as may be . . . prescribed by the Secretary or his delegate."[211] The *Regulations*[212] give examples of situations that merit the allowance of the revocation. A change in the nature of partnership business, a substantial increase in the assets of the partnership, a change in the character of partnership assets, or increased administrative burden to the partnership because of an increased frequency of retirements or shifts of partnership interests are cited as reasons for revocation. A "primary purpose" test is contained in the regulation to the effect that revocation will be denied where the primary purpose in seeking the revocation is to avoid the decrease in the basis of partnership assets upon a transfer or distribution. It follows that revocation is probably not available when the partnership's adjusted basis in its assets exceed: (1) the market value of the partnership assets for purposes of transfers of partnership interests, or (2) the respective partners' adjusted basis in their partnership interests. The application would, no doubt, also fail if a transfer or distribution resulting in a basis step-down occurred in the year to which revocation, if granted, would be effective.

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209 It does not appear that insanity alone is a reason for dissolution of the partnership. *See,* UNIFORM PARTNERSHIP ACT § 31.

210 *See* Stern & Co. v. State Loan & Finance Corp., 238 F. Supp. 901 (D. Del. 1965).

211 INT. REV. CODE of 1954, § 754.

212 Treas. Reg. § 1.754-1(c) (1956).

B. *The Section 732(d) Election*

Unlike the requirement of section 754, section 732(d) requires the election to be made and filed by the individual partner. Since the partnership is not affected by the election, it need not make a decision on the matter. The *Regulations*[213] provide that the election is to be made by way of a schedule, included in the transferee's income tax return, declaring the election and including a computation of the special basis adjustment and a schedule of the properties to which it is applied. Also, unlike the section 754 election, this election is not stated by the *Regulations* to be a continuing one, so that if within two years of the acquisition of the partnership interest the transferee partner receives distributions to which section 732(d) is applicable in different tax years, separate elections appear to be necessary.

The proper time for filing the election depends upon the type of property distributed. If the property is subject to an allowance for depreciation, depletion, or amortization, the election must be filed in the transferee partner's year of distribution. If other property is distributed, the election must be made "in the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax . . . ."[214]

CONCLUSION

The provisions of the *Code* governing the transfer of a partnership interest and distributions are, indeed, very complex. The tax ramifications of any transaction in this area may span a number of *Code* provisions and identification of what *Code* provisions apply is a difficult task for anyone without an intimate knowledge of the intricacies of subchapter K. Although reform measures have been considered by Congress, to date the provisions of the 1954 draft have gone unchanged.[215]

The Commissioner has not been helpful in interpreting the *Code* provisions. For instance, a person looking for information about a distribution problem must look to not only the *Regulations* covering the distribution provisions of the *Code* but also to the *Regulations* dealing with transfers of a partnership interest to completely cover the problem. Where Congress has directed the Commissioner to promulgate rules, the results often appear to be unduly strict and, sometimes, unworkable.

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[213] *Id.* § 1.732-1(d)(3) (1956).
[214] *Id.* § 1.732-1(d)(2) (1956).
[215] Anderson & Coffee, *supra* note 6, for an analysis of the proposed revisions.

Some of the questions raised by the *Code* and *Regulations* have been answered with clarity by the courts. However, litigation has covered only a small portion of the problems which arise in the area. The confusion which attends distributions and transfers in the *Code* and *Regulations,* in turn breeds case law which reflects an equitable approach rather than an approach based on the statutory policy.[216] This is undesirable, particularly to the litigant whose case is decided by a court which properly finds that equity is not a part of the taxing system. Uniformity is necessary but is by no means furthered by the *Code* provisions discussed herein.

The burden is placed upon the attorney representing one of the parties to the transaction to be, at the least, aware of the pitfalls and traps in this area of partnership income tax law. The outcome of a transfer or a distribution in the absence of an awareness of the *Code's* provisions and the case law may be devastating, costly, and very discouraging to the client.

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[216] In Barnes v. United States, 253 Supp. 116 (S.D. Ill. 1966), the court emphasized the inequity of the statute as applied to the taxpayer.

PARALEGALS AND SUBLEGALS: AIDS TO THE LEGAL PROFESSION

BY HOWARD K. HOLME*

In order to meet the rapidly growing need for legal services, the author thinks lawyers must analyze and standardize routine legal functions. Non-lawyers should be hired and trained as "sublegals" to perform these routine jobs that lawyers now perform. Lawyers and law schools should also help train "paralegal" personnel who, like welfare workers and claims adjusters, are not under the direct supervision of attorneys, but need legal knowledge in addition to their other skills. A comparison of the legal and medical professions demonstrates the wisdom of recognizing and regulating nonprofessionals rather than forcing the marketplace to provide undertrained and unregulated competing occupations. Much research and development is needed to upgrade the subordinate and complementary occupations to the law.

INTRODUCTION

MANY of the problems plaguing the legal profession today — high cost, long delays, some lawyers going without work, while, at the same time, many people who need legal services are unable to obtain them[1] — have existed, and have remained unsolved, for over 50 years. But if the legal profession has been under fire for not providing legal services to those in need, it had better prepare for a far greater onslaught in the future. The growth of legal need, far faster than the growth of population, is due both to the changing society and a changing perception of the law. Increasing education, income, and accumulated wealth of Americans are leading to greater demands for legal services. Perhaps more important is society's changing perception of legal services not as a privilege, but as a right.[2]

The thesis of this article is that the legal profession can best respond to the increasing demand for legal services by providing some legal services through "paralegal" or "sublegal" personnel. The increasing need for legal services, the differing ways the legal and medical professions have met the need for new services in

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[1] *E.g.,* R. SMITH, JUSTICE AND THE POOR (1919). The detailed table of contents would be entirely suitable for a book describing the inefficient American administration of justice today — 50 years later.

[2] Numerous Legal Aid and Public Defender programs are examples of this trend. Mandatory representation of welfare recipients by lawyers at administrative proceedings is additional evidence of this change. *See* Robb, *HEW Legal Services: Beauty or Beast?,* 55 A.B.A.J. 346, 347 (1969).

their respective fields, and the current paralegal training efforts and areas of utilization of paralegals are the subjects discussed.

Because the concept of non-lawyers providing legal services is new, there is little established nomenclature. Such terms as "trained, non-lawyer assistants," "lay assistants for lawyers," "legal assistants," "legal technicians," and "legal subprofessionals," are used to describe what are here called the "sublegals" and "paralegals." "Sublegal" and "paralegal" are used here because the terms are more precise and concise than, for instance, "paraprofessional."

The "sublegal," for the purposes of this article, is the person who works under the supervision of a lawyer, usually in a law office. He performs some of the routine work which does not require full legal training. An obvious example of a sublegal is an experienced legal secretary. The "paralegal" is one who is not a lawyer, nor under direct supervision of a lawyer, but who needs some legal training to do his job well. Examples of paralegals are welfare workers, insurance adjusters, and probation officers. Similar *work* might be described as sublegal or paralegal, depending upon the supervisor. For instance, a housing specialist working with zoning, housing code enforcement, or racial discrimination might be called sublegal if he was supervised by a lawyer, or paralegal if his work was not examined by a lawyer.

Lawyers can have a major role to play, if they choose, in the initiation and implementation of plans concerning the distribution of legal "know-how." Lawyers can have a dominant voice in determining how their legal secretaries and clerks are trained before beginning work, as well as how they are trained on-the-job. Lawyers can also contribute to occupations not controlled by themselves. By providing legal training for paralegals, attorneys can serve the public by providing competent personnel who can do less complex work, at less expense, in more available settings.

If lawyers do not choose to shape their own destiny, the marketplace will do it for them. Karl Llewellyn recognized that despite unauthorized practice committees and licensing of attorneys, the marketplace was already at work.[3] As Llewellyn looked at claims that "encroachers" were engaged in the unauthorized practice of law, he concluded that: (1) "Old lines of business are certainly drifting or being sucked into non-bar hands, but with real probability that this is because they are being done more adequately or more cheaply or both by outside agencies, first; and second, because

[3] Llewellyn, *The Bar's Troubles and Poultices — and Cures?*, 5 LAW & CONTEMP. PROB. 104, 107 (1938).

those outside agencies are making their serviceability *known* . . . .";[4] (2) "much business which has never reached lawyers at all . . . much business which has only in the last decades come into existence at all . . . has been *discovered* and has been *elicited* from 'the public' by these other agencies";[5] and (3) "[encroachers] are specialists; each has worked out machinery for handling with maximum use of pattern, forms, routine, and concentration of expensive executive decision, *a semi-mass production of legal transactions or legal services* in a very limited field."[6]

I. BACKGROUND AND RATIONALE

There are several factors that help to explain the need for and the potential success of sublegal and paralegal training now being considered by bar groups. The growth and urban concentration of the population, increased education and income, and the growing complexity of the law create an increased need for legal services. The relative lack of technological progress in the law, increased competition among firms in an urban environment, and the increased role of the government in the average person's life indicate a need for cheaper and more accessible legal services. Also, occupational trends indicate the increased availability of qualified personnel needed for the sublegal and paralegal jobs. These trends include a greater percentage of women working, a greater percentage of white collar workers, and rapid growth in professional, technical clerical, and various subprofessional occupations.

A. *Endorsement of the Concept*

Only in the last two or three years have leading groups in the profession begun thinking about the basic concept of training individuals, who are neither lawyers nor law students, to handle some legal problems. In August, 1968, the House of Delegates of the American Bar Association endorsed attorney use of non-lawyer assistants by resolving:

> (1) That the legal profession recognize that there are many tasks in serving a client's needs which can be performed by a trained, non-lawyer assistant working under the direction and supervision of a lawyer;
>
> (2) That the profession encourage the training and employment of such assistants. . . .[7]

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[4] *Id.* at 112.

[5] *Id.* at 113.

[6] *Id.*

[7] *Proceedings of the House of Delegates: Philadelphia, Pennsylvania,* August 5-8, 54 A.B.A.J. 1017, 1021 (1968).

At the same meeting, the A.B.A. set up the special committee on Lay Assistants for Lawyers.[8]

A report by the American Assembly on Law and the Changing Society stated:

> Law Schools, in co-operation with the organized bar, should consider the development of education and training programs for subprofessional personnel. People have needs for domestic relations counseling, consumer advice, small accident reparations, and small claims settlements which the organized bar is not able to provide sufficiently under the present structure of legal practice.[9]

The *Report of the Chairman of the Committee on Curriculum* of a conference of the Association of American Law Schools, held at the University of Denver in 1968, recognized that "the need for highly professional lawyers and the lack of an adequate supply raises the question of increased reliance by the profession on paraprofessional (sometimes called sub-professional) personnel to perform less demanding tasks now undertaken by licensed attorneys."[10]

The belief that paralegal and sublegal occupations should be developed is not confined to the legal profession. The Federal Government, through the National Commission on Technology, Automation, and Economic Progress, has called for the designing of more than 5 million socially useful subprofessional jobs in a wide variety of fields. In sympathy with these needs, the United States Congress passed the Scheuer-Nelson Act[11] which provided $70 million for the development of this goal.[12] These occupations promise to employ some relatively undereducated and unskilled persons in needed and personally rewarding jobs.

B. *Need for More Legal Services*

Population growth and urban concentration are two of the factors that must be considered in the increasing demand for legal services. Table 1 shows that between 1950 and 1960 the nation's

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[8] *Id.*

[9] THE AMERICAN ASSEMBLY ON LAW AND THE CHANGING SOCIETY, REPORT OF THE AMERICAN ASSEMBLY ON LAW AND THE CHANGING SOCIETY 7 (1968).

[10] C. Meyers, Association of American Law Schools, Report of the Chairman of the Committee on Curriculum 1, Nov. 1968 (on file at the University of Denver College of Law, Administrative of Justice Program). *See also* UNIVERSITY RESEARCH CORP., PARAPROFESSIONALS IN LEGAL SERVICES PROGRAMS: A FEASIBILITY STUDY 14-19 (1968) [hereinafter cited as PARAPROFESSIONALS], for others who have called for thought and action on this subject.

[11] Economic Opportunity Amendments of 1967, Pub. L. No. 90-222, 81 Stat. 672 (codified in scattered sections of 42 U.S.C.).

[12] Harrington, *Introduction* to F. RIESSMAN, NEW CAREERS: A BASIC STRATEGY AGAINST POVERTY 3 (undated) (A. Philip Randolph Educational Fund, New York, N.Y.). *See also Id.* at 7.

population increased by 19 percent[13] and changed from 64 percent urban to 70 percent urban.[14] Colorado's population increased 32 percent from 1950 to 1960[15] and changed from 63 percent urban to 74 percent urban.[16] The population of the Denver metropolitan area increased by 52 percent from 1950 to 1960.[17]

TABLE 1[18]

Population Increase and Urban Concentration

Population x 1000	1950	1960	% Increase	% Urban 1950	% Urban 1960
U.S.	152,271	180,684	19	64	70
Colorado	1,325	1,754	32	63	74
Denver	612	929	52	100	100

The additional population necessitates at least a proportionate growth in the need for governmental regulation and for legal services. Urban concentration leads to more laws and ordinances with which to comply, and more legal problems resulting from increased personal and business relationships. Government on all levels and the legal system have grown enormously, attempting to provide social stability in a society where more people with more power for destruction and more property to destroy are crowded together in increasingly tense and densely populated cities.

One governmental means of social control has been to define, to a large extent, economic and social values. This process can be seen in the granting or withholding of a license to practice a regulated occupation, or in the placement of the "poverty line," which determines whether one is eligible for welfare assistance. Professor Charles Reich, in his brilliant article, "The New Property,"[19] points out the many forms of "government largess," and indicates that the local, state, and federal "largess" now constitute 40 percent of the total personal income in the United States.[20] Inevitably, as government control is extended over an area, laws or administrative regulations are instituted, and lawyers are summoned to interpret and

[13] UNITED STATES BUREAU OF THE CENSUS, DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 1967 at 5 [hereinafter cited as ABSTRACT].

[14] *Id.* at 17.

[15] *Id.* at 14.

[16] *Id.* at 17.

[17] COLORADO STATE PLANNING DIVISION, COLORADO YEAR BOOK 1962-64, at 378 (1965).

[18] Table 1 is compiled from ABSTRACT, *supra* note 13, at 5, 14, 17 and COLORADO STATE PLANNING DIVISION, COLORADO YEAR BOOK 1962-64, at 378 (1965).

[19] Reich, *The New Property,* 73 YALE L.J. 733 (1964).

[20] *Id.* at 737. Reich notes the 1961 total governmental expenditures as $164,875,000,000 into which is divided total personal income of $416,432,000,000.

dispute the decisions of governmental authorities; the need for legal counsel multiplies.

Social welfare payments are one example of "government largess." Payments are up from $8.9 billion in 1945 to an estimated $88 billion in 1966,[21] a ten-fold increase. Two recent decisions, however, will further increase both the number of people on welfare (now 8,000,000[22]) and the lawyers' role in welfare. First, the Supreme Court struck down residency requirements for welfare recipients as unconstitutional.[23] Second, recipients or potential recipients have the right to counsel at "administrative fair hearings."[24]

Though it may seem paradoxical, especially to those aware of the crushing legal problems of the poor and the ignorant, there are indications that increased education[25] and income[26] lead to more legal problems. In Gresham Sykes' study, *Legal Needs of the Poor in the City of Denver,* researchers found positive correlations between income, education, and the number of legal problems.[27] In Sykes' sample, half of which fell below the poverty line, 60 percent of those households with no income and 51 percent of those with $1 to $25 weekly income had no legal problems. A smaller percentage of the households with greater income had no legal problems — only 23 percent of households with weekly incomes of $100 to

21 ABSTRACT, *supra* note 13, at 283.

22 Robb, *supra* note 2, at 347.

23 Shapiro v. Thompson, 394 U.S. 618 (1969).

24 Robb, *supra* note 2, at 347, *citing* 45 C.F.R. § 205.10, Fed. Reg. 1144 (1969).

25 YEARS OF SCHOOL COMPLETED BY COLOR AND SEX 1950-66

		% Completed Four Years of High School or More	% Completed Four Years of College or More	Median School Years Completed
1950 (age 25 or older)	White	35.4	6.4	9.7
	Non-white	13.2	2.2	6.8
1960 (age 25 or older)	White	43.2	8.1	10.9
	Non-white	21.7	3.5	8.2
1966 (age 25 or older)	White	52.2	10.4	12.1
	Negro	27.8	3.8	9.1
1966 (persons 25-29 years old)	White	71.0	14.0	12.5
	Non-white	50.4	8.3	12.0

(The median years of education of the entire United States population increased from 8.6 in 1940 to 12.0 in 1966.) ABSTRACT, *supra* note 13 at 114, 116.

26 Increased American affluence is evident. Per capita disposable personal income, measured in constant 1958 dollars, increased from $1,646 in 1950 to $1,883 in 1960 and to an estimated $2,294 in 1966, an increase of almost 22 percent from 1960 to 1966. ABSTRACT, *supra* note 13, at 321.

27 G. Sykes, Legal Needs of the Poor in the City of Denver 33-34, 1968; (mimeographed report at the University of Denver College of Law, Administration of Justice Program); to be published in 4 LAW AND SOCIETY REV. no. 2 (1969).

$150, and only 17 percent of those with over $150 weekly income had no legal problems.[28] As to education, 54 percent of those with eight years of schooling or less had one or more legal problems while 69 percent of those with nine or more years of school had one or more legal problems.[29]

Better educated and more affluent people not only have more legal problems, they are better able to recognize which problems can be resolved by a lawyer. Sykes' study indicated that poor people often did not recognize that problems with workmen's compensation, unemployment benefits, and welfare benefits might be alleviated with the help of a lawyer. In fact, Sykes found that over two-thirds of the legal needs of the poor in Denver were both untreated and unrecognized.[30] However, Sykes found that when a problem was recognized as having legal implications, 78 percent of those interviewed went to consult a lawyer.[31]

One final factor to consider in the need for increased legal services is the growing complexity of the law. Much creative talent is needed to solve our present and future legal problems. Using scarce professional talent will be increasingly unfeasible for routine or simple jobs; instead, the use of sublegals should free attorneys to focus their attention on more difficult problems.

C. *The Need for Less Expensive and More Available Legal Services*

Even though the United States is comparatively wealthy and urban, relatively inexpensive and more efficient legal services are needed. The legal profession especially needs efficiency, because it depends so much on creative thinking and so little on capital investment and mechanization. Sublegal training seeks to lower costs by training a larger number of lower-paid workers, who specialize in a very small area of the law, using standarized procedures and forms. Can anyone doubt that the labor cost of a routine legal service

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[28] *Id.* at 34. Sykes hypothesized that one reason for the positive correlation between income and legal problems is that money leads to greater participation in society, which leads to more legal problems. *See also* Schwartz, *Foreword: Group Legal Services in Perspective,* 12 U.C.L.A.L. REV. 279, 286 (1965). Obviously, the money, if not the personage, of a Rockefeller is inevitably involved in many enterprises and many conflicts. Another possible reason for the positive correlation is that society has identified and legitimized the complaints and conflicts of the rich, but not the poor. It has been difficult for poor people to establish any new "rights" to anything. Until a person has the right to something, the denial of that something is not usually recognized as a legal problem. Thus, the poor may be denied legal problems by definition.

[29] *Id.* at 33.

[30] Sykes, *supra* note 27 at 28.

[31] *Id.* at 25.

has the potential for being low in an office where three attorneys have twenty or more non-lawyer aides?[32]

Another compelling reason for the legal profession to strive for efficiency is its moral duty to provide services to all people having legal needs, at a fee they can pay. In 1963, Legal Aid and Legal Services received only 0.2 percent of the money spent for all legal services.[33] The great extension of legal services to the poor funded by the Federal Government has meant that a growing number of lawyers have been devoting their time to the poor, but this group is still very small. In early 1969 there were 645 legal service centers and 315 defender offices.[34] However, of the almost 320,000 lawyers in the United States,[35] 2,300, or less than 1 percent, are devoting their full time to the civil problems of the poor.[36]

A very direct measure of the need for more and less expensive legal services is the attorney's income. The poor and many others simply cannot afford to pay what most lawyers charge. Fees are rising, as is indicated by increased earnings by lawyers. In 1959, the median earnings of lawyers and judges was $10,587.[37] From 1961 to 1966 (a period during which the Consumer Price Index rose 7 percent),[38] the average attorney's earnings increased by 20.8 percent; New York City serves as an extreme example,[39] by 1969 some starting salaries exceeded $15,000. Wall Street firms could not pay these wages and serve the poor. In fact, few firms in New York City do. Seventy percent of the New York lawyers in one survey said the median income of their clients was over $10,000, while only 10 percent of the city population had income over $10,000.[40] In contrast, only 5 percent of the attorneys served clients with median income under $5,000.[41]

Law offices, as well as the client, need efficiency in legal services. An increase in the number of lawyers means a greater selection for

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[32] PARAPROFESSIONALS, *supra* note 10, at 71 *et seq.*

[33] Carlin and Howard, *Legal Representation and Class Justice,* 12 U.C.L.A.L. REV. 381, 410 (1965) [hereinafter cited as *Legal Services*].

[34] Toll and Allison, *Advocates for the Poor,* 46 DENVER L.J. 85 (1969).

[35] AMERICAN BAR FOUNDATION, THE 1967 LAWYER STATISTICAL REPORT 12 (F. Weil, ed. 1968) [hereinafter cited as STATISTICAL REPORT].

[36] Robb, *supra* note 2, at 346.

[37] ABSTRACT, *supra* note 13, at 232.

[38] *Id.* at 355.

[39] *Id.* at 240. In 1953, the starting salary for attorneys on Wall Street was $4,000. Smigel, *The Impact of Recruitment on the Organization of the Large Law Firm,* 25 AM. SOCIOLOGICAL REV. 56, 61 (1960).

[40] *Legal Services, supra* note 33, at 382.

[41] G. BRAGER & F. PURCELL, COMMUNITY ACTION AGAINST POVERTY 293 (1967).

the client. The resulting competition demands efficiency. Larger law firms develop and specialize, and lawyers within firms specialize even more. Fewer single practitioners are able to succeed and more non-lawyers and associates are used in law offices. The trends can be seen in Table 2.

TABLE 2[42]
National Distribution of Attorneys by Percent

	Total Priv. Prac.	Individual Practice	Partners	Associates
National 1954	85.5	57.5	23.3	4.7
1966	73.5	39.1	27.1	7.2
Colorado 1966	74.6	39.2	27.9	7.4
Denver 1966	73.0	37.1	27.1	8.8

II. OCCUPATIONAL AND PROFESSIONAL TRENDS

A. *General Occupational Trends*

Various occupational trends are relevant to a consideration of sublegal or paralegal training. Rising white collar employment is part of the general shift of our economy from a production orientation toward a service orientation. While nonwhites still face many barriers to gaining white collar jobs, Table 3 demonstrates that the percentage of nonwhite workers holding white collar jobs doubled from 1950 through 1966.

TABLE 3[43]
Employed Persons by Occupation and Color

	% White			% Nonwhite		
	1950	1960	1966	1950	1960	1966
White-collar	40.3	46.4	47.9	10.2	16.0	20.8
Professional & Technical	8.0	12.0	13.3	3.0	4.7	6.9
Clerical	13.8	15.6	16.8	3.5	7.2	9.4

The number of professional workers has grown even faster than the number of white-collar workers. As shown by Table 4, the experienced male labor force grew 6.9 percent from 1950 to 1960 while the number of experienced male "professional, technical, and kindred" workers grew 50.2 percent. The very rapid growth of particular occupations especially suitable for paralegal or sublegal training, including social workers, real estate and insurance salesmen, and law enforcement personnel, is also notable.

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[42] STATISTICAL REPORT, *supra* note 35, at 18, 48, 88.

[43] ABSTRACT, *supra* note 13, at 231.

TABLE 4[44]

Experienced Civilian Labor Force, by Sex and Occupation
1950 and 1960, and by Selected Characteristics, 1960
(Persons 14 years old and over.)

SEX AND OCCUPATION	1950	1960 Total	% Inc. 1950-60	1960 Nonwhite Percent	Median Earnings 1959
Male and Female	59,229,531	67,990,078	14.8	10.6	3,845
MALE	42,722,297	45,686,330	6.9	9.6	4,621
Professional, technical, and kindred workers	3,024,631	4,542,702	50.2	3.5	6,619
Accountants and auditors	328,420	396,343	20.7	1.4	6,611
Lawyers and judges	176,063	205,515	16.7	1.3	10,587
Physicians and surgeons	181,069	213,918	18.1	4.0	14,561
Social, welfare, and recreation workers	33,556	58,347	73.9	11.1	4,961
Technicians	46,180	141,653	206.7	5.7	5,449
Medical and dental	34,231	52,892	54.5	10.0	4,503
Officials and inspectors, state and local administration	112,539	135,816	20.7	2.0	5,554
Other clerical and kindred workers (excluding book-keepers and mail carriers)	2,388,183	2,769,774	16.0	6.8	4,736
Insurance agents, brokers, underwriters	250,755	333,126	32.8	1.9	6,173
Real estate agents and brokers	122,319	148,957	21.8	2.1	5,978
Policemen, sheriffs, and marshals	216,176	276,976	28.1	3.9	5,210
FEMALE	16,507,234	22,303,748	35.1	12.8	2,257
Professional, technical, and kindred workers	1,975,847	2,792,997	41.4	7.2	3,625
Accountants and auditors	56,884	80,483	41.4	2.5	4,209
Lawyers and judges	6,348	7,543	18.8	2.6	5,199
Nurses, professional	395,638	577,038	45.8	6.5	3,186
Social, welfare, and recreation workers	60,291	78,017	29.4	12.4	4,074
Technicians, medical and dental	44,154	87,944	99.2	7.8	3,180
Clerical and kindred workers	4,408,498	6,497,350	47.4	3.6	3,017
Office-machine operators	120,348	236,413	96.4	5.0	3,242
Secretaries	781,324	1,451,639	85.8	2.0	3,368
Stenographers	416,844	264,157	-36.6	2.8	3,340
Typists	339,875	516,844	52.1	6.7	2,801
Other clerical and kindred workers	1,640,844	2,501,968	52.5	4.8	2,852
Insurance and real estate agents and brokers	45,979	82,889	80.3	4.4	3,018

Projections from 1965-1975 show a continuation of the trends indicated by Table 4. Total employment is expected to rise by 22.8 percent, while employment in specific occupational groups will rise as follows: professional, technical, and kindred — up 45.2 percent; clerical and kindred — up 30.8 percent; all service producing in-

[44] *Id.* at 232-35.

dustries — up 31.9 percent; total government — up 39.1 percent; Federal Government — up only 10.8 percent.[45]

The rapid growth in participation of women, especially white women, in the labor force indicates there will be many people suitable for sublegal or paralegal training. As indicated in Table 5, for instance, in 1960, 35 percent of white women over 14 worked. The projection for 1980 is that 40 percent will be working, an increase of 11 million workers.

TABLE 5[46]

Labor Force — Total, and Participation Rates by Color and Sex: 1960 and Projections, 1970 and 1980

COLOR AND SEX	TOTAL LABOR FORCE (In thousands of persons 14 years old and over) 1960	1970	1980	PARTICIPATION RATES (percent) 1960	1970	1980
TOTAL	73,081	85,999	101,408	57.4	57.5	58.3
MALE	49,563	55,844	64,981	79.7	77.0	77.2
White	44,666	50,027	57,596	80.0	77.3	77.5
Nonwhite	4,897	5,815	7,387	77.0	74.3	75.0
FEMALE	23,518	30,155	36,427	36.1	39.1	40.6
White	20,391	26,245	31,541	35.0	38.3	40.0
Nonwhite	3,127	3,910	4,886	45.5	45.4	45.0

B. *Medicine and Law*

A number of trends in the professions are very important to subprofessional and paraprofessional training and occupations. One is the general growth in expenditures and technology. Another is the increasing specialization, whether formal or informal, by the professionals themselves. The use of subprofessionals, is obviously vital, as is the process by which paraprofessionals assume jobs which formerly were performed by professionals.

1. General Growth

The improvement of health services has been a high national priority during the last 20 years. The $40,751,000,000 health expenditures of 1965 showed an increase of 217 percent from 1950.[47] Medical care expenses represented 6.5 percent of the national personal consumption for 1965, up from 4.6 percent in 1950.[48] In another mode of comparison, national income by industrial origin, medical and other health expenditures rose from $4.4 billion in 1950 to $17.5 billion in 1966 (up 298 percent), while legal services rose

[45] H. Sheppard, The Nature of the Job Problem and the Role of New Public Service Employment, Jan. 14, 1969 (W. E. Upjohn Institute for Employment Research, Kalamazoo, Mich.).

[47] *Id.* at 70.

[48] *Id.* at 323.

from $1.3 billion to $4.3 billion (up 231 percent).[49] Thus medical expenses grew substantially faster than legal expenses, even when starting from a much larger base.

Tremendous amounts of money have been expended for the research, construction, and machines of medical science. Medical research expenditures increased 1174 percent from 1950-65, and as of 1967 were $1.5 billion.[50] In 1965 nearly $2 billion was spent for construction of medical facilities.[51] Much of this money went for computers and other complex machinery. Few people need to be reminded of medicine's technological progress in these days of artificial hearts and organ transplants. In the law, a computerized index to briefs[52] is still a dream and it is an unusual law office that even uses a magnetic tape typewriter.

2. Specialization

Specialization has occurred in the law,[53] but it is generally informal. The *1967 Economic Survey of the Colorado Bar* showed that approximately 59 percent of Colorado lawyers in private practice who answered the questionnaire are highly specialized — 50 percent or more of the lawyer's time is devoted to one field of law. The degree of specialization, furthermore, seems to have increased markedly since the last survey in 1961.[54] The extent and speed of specialization is somewhat difficult to determine, partially because the American Bar Association and other groups have been so slow to recognize or regulate the trend.[55]

In contrast to the legal profession, the medical profession started certifying specialists in about 1920. Now there are at least 19 certified medical specialities, many of which are dividing into subspecialities.[56] Specialization in medicine occurs only after the four-year, regular course and one-year internship. Residencies leading to specialization are very rigorous, often requiring several more years of study.

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49 *Id.* at 325.

50 *Id.* at 70.

51 *Id.*

52 C. Decker, Institutionalization of Defender Services 6, undated (on file at National Legal Aid and Defender Ass'n, Washington, D.C.).

53 *See generally* Greenwood and Frederickson, *Specialization in the Medical and Legal Professions,* 5 L. OFFICE ECON. & MAN. 175 (1964).

54 THE ECONOMICS OF LAW PRACTICE COMMITTEE OF THE COLORADO BAR ASSOCIATION, REPORT ON THE 1967 ECONOMIC SURVEY OF THE COLORADO BAR 4 (1968) [hereinafter cited as ECONOMIC SURVEY].

55 *See* C. Smith, *Specialization in the Law* in PROCEEDINGS OF THE THIRD NATIONAL CONFERENCE ON LAW OFFICE ECONOMICS AND MANAGEMENT 9 (prepared by the Standing Committee on Economics of Law Practice of the American Bar Ass'n, 1969).

56 Cheatham, *The Growing Need for Specialized Legal Services,* 16 VAND. L. REV. 497, 502 (1963).

Formal specialization may cause increased acceptance of subprofessionals and paraprofessionals. Medicine is formally specialized and uses many subprofessionals, while law is not formally specialized and does not use many subprofessionals. Furthermore, the man who is secure in the status of his job may be more willing to hire subprofessionals than a man with less prestige, who may feel threatened by the presence and competence of a subprofessional. It may be that the specialists in medicine brought in the technicians and paramedicals, while the general practitioners objected. In the American Bar Association, the General Practice Section was the group most resistant to the formation of the Lay Assistants Committee.[57] The widespread use of sublegals may not occur until the movement toward formal legal specialization is further advanced.

3. Subprofessionals

While in recent years, the number of lawyers has grown faster than the number of doctors, medicine has had a much faster growth in the number of recognized and trained subprofessionals. The number of doctors increased 31 percent from 233,000 in 1950 to 305,000 in 1965,[58] while lawyers increased 43 percent from 222,000 in 1951 to 317,000 in 1966.[59] From 1950 to 1965, the number of nurses was growing twice as fast as that of doctors, and by 1965 there were twice as many nurses as doctors.[60] Projections from 1965-1975, when the number of doctors will probably grow less than 20 percent, suggested that other groups will grow as follows: nurses up 42 percent, rehabilitative and other technicians up 54 percent, medical laboratory personnel up 60 percent, and X-ray technologists up 73 percent.[61]

In 1965 doctors constituted approximately 10 percent of those employed in health services,[62] while lawyers probably constitute over 50 percent of the legal profession. The *1967 Economic Survey of the Colorado Bar* indicates that a very large majority of Colorado law offices have a ratio of one secretary or less per lawyer.[63]

4. Paraprofessionals

In general, the medical profession has accepted, trained, and supervised its subprofessionals or "paramedicals." One need only

[57] Conversation with Kline Strong of the A.B.A. Special Committee on Lay Assistants for Lawyers, in Denver, Colorado, Mar. 1969.

[58] ABSTRACT, *supra* note 13, at 66.

[59] STATISTICAL REPORT, *supra* note 35, at 12.

[60] ABSTRACT, *supra* note 13, at 66.

[61] *Id.* at 67.

[62] *Id.* at 66, 67.

[63] ECONOMIC SURVEY, *supra* note 54, at 14.

consider the lengthy training of nurses or pharmacists, which leads to degrees and state licenses, to see the extent to which the entire medical profession is trained and regulated. An example of medical regulation is the bill passed in Colorado for "child health associates," who could handle up to 80 percent of the routine medical cases involving children. The associates would work in doctors' offices after five years of post-high school training and would be appropriately licensed.[64]

The attitude of the legal profession toward paraprofessionals is very different from that of the medical profession and is exemplified by the unauthorized practice of law committees. Rather than training non-lawyers to deal with legal matters, the profession has tried to prevent all non-lawyers from performing this type of work. Campaigns have been waged by bar association committees to prevent real estate brokers from filling in the blanks on a form contract, and to prevent insurance company adjusters from settling some claims.

The unauthorized practice committees were formed in the depression of the 1930's. The zealousness of the committees in bringing suits against "encroachers" has been less in prosperous times than in lean, as might be expected of groups which are protecting their economic livelihood as well as the public interest.[65] The committees have been influential enough, for over 30 years, to discourage the consideration of paralegals as an integral part of the profession, and have been a major factor in the dichotomy between paralegals and sublegals.

C. *Sublegal and Paralegal Occupations*

At this point, a discussion of a number of jobs — some sublegal, some paralegal — performed in connection with law offices, courts, the executive and legislative branches of the government, financial institutions, real estate offices, insurance companies, tax specialists, and other businesses is in order.

The law office is the logical place to find the sublegal — the legal secretary probably being the first known to the profession. Yet to be meaningfully classified as sublegal, the secretary should do more than take dictation and type. To be classified as sublegal, one should be a person with some training, as well as supervision, who helps the lawyer by actually performing some of his tasks.

Several factors characterize the jobs which can be successfully accomplished by sublegals. These jobs are high volume, and amenable to standardization of forms, and routinization of procedures.

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[64] Child Health Associate Act, Colo. H.R. Bill no. 1169. Signed into law July 14, 1969, effective date Sept. 1, 1969.

[65] Llewellyn, *supra* note 3, at 109.

They are broken down into separate steps, which are often listed on checklists used by the sublegal.[66] One firm, with three attorneys and 23 lay personnel, has developed procedures and checklists for 33 different office and legal functions.[67]

Many tasks such as those described in Jerome Carlin's book, *Lawyers on Their Own*,[68] are capable of being performed by secretaries in most law offices, yet single practitioners are doing these tasks. It might even be argued that some law schools really offer paralegal training, because the men who graduate from those schools do routine and simple work, not needing a complete legal education. In this context, Carlin mentions corporate jobs such as establishing or dissolving corporations and preparing and filing routine papers.[69] He also includes real estate jobs, including work on purchase agreements, applications for mortgages, title guarantee policies, escrow accounts, leases, landlord tenant squabbles, rent collections, and evictions.[70] Personal injury work, which in some cases could be handled by subprofessionals, includes building the file, preparing and explaining the retainer contract, interviewing, factual investigating, and gathering the proof of special damages.[71] Other similar work involves negotiating with a claims adjuster (a paralegal), and preparing and filing court papers to bring suit.[72] Estate planning, drafting of trusts, and preparation of wills also may involve much work capable of being performed by a subprofessional. Carlin noted that Chicago banks often do the preparation and drafting of wills in return for an agreement that the bank be the executor.[73] Probate clerk sublegals may prepare and file an inventory of assets, prepare estate tax returns, make status of accounts reports, and transfer securities to beneficiaries.[74]

Carlin's study concerns the single practitioner rather than the sublegal, but the individuals he studied were forced to do jobs that

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[66] PARAPROFESSIONALS, *supra* note 10, at 73.

[67] PARAPROFESSIONALS, *supra* note 10, at 99 n.26 lists these functions as: accounting, appeals to Supreme Court, appointments, billings, brief files, calendar, corporations, corporation dissolution, depositions, distribution of incoming mail, Federal Court removals, filing and out cards, friendly hearings, insurance-liability defenses, interrogatories-incoming, interrogatories-outgoing, library, office procedure memo, payroll, pleadings, real estate specialists, subrogation, supplies, telephone ticklers, trainer of new personnel, transcription, trials, workmen's compensation-defense, workmen's compensation-claimant.

[68] J. CARLIN, LAWYERS ON THEIR OWN (1962).

[69] *Id.* at 43 *et seq.*

[70] *Id.* at 52 *et seq.*

[71] *Id.* at 71, 72.

[72] *Id.* at 72 *et seq.*

[73] *Id.* at 102. In Denver, "Statement of Principles and Canons of Conduct between the Denver Bar Association and the Trust Departments of the Denver Clearing House Banks," signed in 1936, sets standards for bankers and lawyers.

[74] PARAPROFESSIONALS, *supra* note 10, at 72.

might often be done by sublegals. Carlin, recognizing that these lawyers' jobs are often threatened by lay competition,[75] points out some of the reasons for successful lay competition: (1) convenience and efficiency — lay groups have standardized and simplified the work and are often more accessible to the community; (2) balance of skills and power — lay specialists may often become more skilled in a given area than a general practitioner, and may belong to economically strong groups; (3) visibility in the community — enhanced by advertising restrictions imposed by the canon of ethics; and (4) lower prices charged by the layman.[76] If single practitioners are able to employ sublegals, they may be able to escape both the threat of losing their source of income, and the task of having to do routine and undesirable jobs.

Some legal services programs have explored the possible utilization of sublegals.[77] Sublegals can alleviate two of legal aid's greatest problems, the overwhelming caseload and the isolation of the profession from many poor people in the community.

Uncontested divorce cases provide an outstanding example of the usefulness of sublegals. Such cases provide about 50 percent of the work load of a typical legal aid office.[78] Legal aid lawyers become frustrated and bored because they spend so much of their time doing routine interviewing and form filling. These mechanical tasks pre-empt the time which would otherwise be available for the difficult and innovative cases which might have far reaching results. The divorce client may just need someone to talk to and may ramble while taking up a lawyer's precious time. The paralegal, with counseling training, could be far more sensitive than the average lawyer in this situation.

Several legal services programs have turned over nearly all divorce work to sublegals.[79] Sublegals can interview the client, using a questionnaire to get all relevant information. Sublegals, with some community experience and a reference list, can refer the client for marriage counseling or advise other steps short of divorce. Sublegals, with a minimum of supervision, can oversee the typing and filing of the complaint and summons, preliminary motions, and all other documents. Any special problems that arise for the sublegal in the divorce action can be referred to the supervising attorney for consultation. Lawyers, of course, retain the ultimate responsi-

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[75] CARLIN, *supra* note 68, at 142 *et seq.*

[76] *Id.* at 143, 144.

[77] *Id.* at 70, 71.

[78] *Id.* at 87. *See generally* Sykes, *supra* note 27, at 46, 47.

[79] PARAPROFESSIONALS, *supra* note 10, at 65.

bility for actual trial proceedings. The savings in time for the lawyers are tremendous.

Another example of the kind of work sublegals can do is the preparation of bankruptcy papers in routine cases. Personal bankruptcy has grown tremendously in the United States, from 33,392 petitions filed in 1950 to 192,354 in 1966.[80] This volume would make it practical for nearly every legal aid office to train a subprofessional to spend much of his time with bankruptcies. Since bankruptcy is a federal procedure, the forms and procedures applicable to one state are applicable elsewhere.

Garnishments are another common legal aid problem. In the Chicago area alone, garnishments have increased from 59,000 in 1962 to 73,000 in 1966.[81] Legal aid offices can often negotiate to prevent garnishments, if they learn of the debt soon enough, and in some cases, overthrow the judgment on which the garnishment is based, because of lack of service of process or other technical defects. Sublegals can help obtain the facts and information, and could negotiate some of the claims. In a Denver neighborhood law office, debt cases made up about 20 percent of the caseload.[82]

Sublegals in legal service programs could also help serve a longtime goal of "preventive law." It has been suggested that sublegals do preliminary interviews or "legal checkups" with clients, using a questionnaire to determine whether the client has unsolved legal problems, some of them perhaps unrecognized.[83] The need for this service was clearly shown in Professor Gresham Sykes' study.[84] This study indicated that a "legal checkup" questionnaire (see appendix) often uncovered more legal problems than did the usual interview with an attorney.[85] The number of unrecognized legal problems among the urban poor was found to be well over twice the number of recognized legal problems.[86]

Sykes' work in Denver showed the need for a bridge between the legal aid offices and the community.[87] Increasing office hours to nights and weekends brought few new clients, but two VISTA lawyers, through their daily contacts with the community, were very helpful in referring individuals with problems to the office.[88] These community contacts were helpful, probably because, while

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[80] ABSTRACT, *supra* note 13, at 499.

[81] D. CAPLOVITZ, THE POOR PAY MORE xviii (1967).

[82] Sykes, *supra* note 27, at 47.

[83] PARAPROFESSIONALS, *supra* note 10, at 87.

[84] Sykes, *supra* note 27.

[85] *Id.* at 23.

[86] *Id.* at 28.

[87] *Id.* at 56; *see also* BRAGER & PURCELL, *supra* note 41, at 200.

[88] Sykes, *supra* note 27, at 51.

the Denver Legal Aid Society has existed for 50 years, only 33 percent of the poor people interviewed knew it existed, and less than 20 percent of these knew even the approximate location.[89] Sublegals could be utilized to acquaint the community with legal aid services.

Intimate knowledge of the community can enable a sublegal to point out particular problems to attorneys.[90] The Dixwell Legal Rights Association (D.L.R.A.) of New Haven, Connecticut, has trained individuals, half of whom have less than a high school education, for this function.[91] During D.L.R.A.'s 3-month training course, about 45 percent of a trainee's time is spent canvassing and serving poor neighborhoods — finding residents who are either inadequately served by various agencies or who qualify for more benefits.[92] The Legal Assistance Association of New Haven has hired many of the trainees.[93]

The sublegal can also be valuable as a "legman," factual investigator, or "guide to the government bureaucracy."[94] Britain's Citizen's Advice Bureaus use sublegals to advise laymen about legal aid (which grew out of the Advice Bureaus), to refer people to other useful agencies, and to perform some of the functions of an ombudsman.[95]

Community knowledge of Legal Aid, its effectiveness, and its use of sublegals are all directly related. An increase in any factor should bring increases in the others. Some legal aid programs have been reluctant to use sublegals, partially because of past experience with local and state bar resistance even to the expansion of Legal Aid use of federal money.[96] In the suburban metropolitan Denver counties, until recently, many lawyers resisted any federal funding of legal aid. A Denver Model Cities program proposing an office staffed primarily with paralegally trained personnel found stiff resistance from the board of directors of the Denver Legal Aid Society before it was approved.

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[89] *Id.* at 39; *see also* BRAGER & PURCELL, *supra* note 41, at 200.

[90] A. PEARL & F. RIESSMAN, NEW CAREERS FOR THE POOR 258 (1968).

[91] D. Hunter, Research Report on Dixwell Legal Rights Association, New Haven, Connecticut, 5, Summer, 1967. (A condensed version of this report may be found in F. RIESSMAN & H. POPPER, UP FROM POVERTY, 1968).

[92] *Id.*

[93] *Id.*

[94] THE CENTER FOR YOUTH AND COMMUNITY STUDIES, HOWARD UNIVERSITY, TRAINING FOR NEW CAREERS 99 (1965).

[95] Address by Professor Monrad G. Paulsen, *The Law Schools and the War on Poverty,* in CONFERENCE PROCEEDINGS: NATIONAL CONFERENCE ON LAW AND POVERTY 77, 81 (1965).

[96] Address by Charles J. Parker, *The Relations of Legal Services Programs with Local Bar Associations,* in CONFERENCE PROCEEDINGS: NATIONAL CONFERENCE ON LAW AND POVERTY 126 (1965).

Without sublegals, the effectiveness of legal aid has been lower. Legal aid has been afraid to make its presence widely known in the community for fear of swamping itself with work. Yet where offices have been swamped with work, some have responded by using sublegals — *e.g.*, the California programs which use sublegals in divorce cases.[97]

Of course, it is not only the private lawyer and the legal aid office that employ sublegals, although these groups may have the greatest potential for using them. The judicial, legislative and executive branches of government also use some sublegals, and many paralegals.

Courts use a number of sublegals and paralegals. Some municipal court judges, county court judges, juvenile court judges, and justices of the peace are not lawyers, although they obviously need legal training.[98]

One new "parajudicial" occupation, which demonstrates the potential for improving the legal profession through the recombination of skills in new occupations, is the "law clerk-bailiff." The job of law clerk-bailiff will be filled by a night law student, who would serve as bailiff, and also as the judge's law clerk, doing legal research for the judge.

"Parajudicial" might also be used to describe referees, masters, and arbitrators. Referees may often be used instead of judges. For example, referees are used exclusively in bankruptcy court. Colorado has passed legislation for the appointment of several water referees to decide water law disputes.[99] Also, in Denver, non-lawyer referees are used in juvenile court to lessen the court's load. These referees have much the same function as judges. Masters may be used by judges to hear and evaluate complicated or time consuming factual information.

The formation of neighborhood courts, having jurisdiction over many minor offenses and juvenile offenses, has been suggested. These courts could help reduce court congestion and would be staffed by paralegally trained neighborhood residents.[100]

One consequence of overcrowded courts and long delays before trials has been the increased use of arbitrators to help alleviate this situation.[101] In complex or technical cases, three arbitrators are

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[97] PARAPROFESSIONALS, *supra* note 10, at 66.

[98] Ronayne *Law School Training for Non-lawyer Judges,* 17 J. LEGAL ED. 197 (1964).

[99] COLO. REV. STAT. ANN. § 148-9-4 (1963).

[100] *See* remarks of Dr. Edgar J. Cahn in PROCEEDINGS OF THE HARVARD CONFERENCE ON LAW AND POVERTY 55-57 (1967).

[101] Merson, *Closing the Confidence Gap: Legal Education's Role,* 46 DENVER L.J. 97, 100 (1969).

often appointed — at least one lawyer and at least one expert from the field in which the dispute arose. It obviously helps if the lawyer also knows the technical field and the expert knows some law.[102]

In the criminal field, subprofessionals may do much of the factual investigation and interviewing of potential witnesses, as well as the preparation for depositions and interrogatories. The police force does the great part of the factual investigation and preparation for the prosecutor, even when he has his own sublegal investigation staff. Presently, only the richer defendants can afford the extensive factual investigation that the prosecution has at its disposal. However, there is a growing recognition of the need for a factual investigation staff for the Public Defender.[103] When the courts have been presented alternatives to sentencing the offender to prison, they have often — about one-third of the time — chosen programs diverting the defendant from prosecution or at least deferring it.[104] The new occupations developed by the project include "program developers" and "follow-up counselors."[105]

Other paralegal occupations supervise the convicted defendant. Probation and parole officers have the difficult job of trying to help the convict rehabilitate himself, as well as to supervise the person and keep him out of trouble. The occupation already combines the difficult roles of social worker and policeman. A knowledge of the criminal law and the criminal justice system is needed in both capacities. Parole board officers must balance the welfare and rights of society and the individual in deciding whether or when to release the convict from prison before the end of his maximum sentence.

The executive branch of the government employs nearly 10 percent of all United States' attorneys.[106] In addition, many of its non-lawyer employees need to know the law governing their particular specialty. Again, the criminal justice system provides an obvious example. Policemen are the front line administrators of the criminal law, yet their training in law most frequently is fairly scanty. One of the best municipal police training academies allots only 20 hours of training in the law out of 480 hours in the recruit

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102 American Arbitration Association, The Lawyer and Arbitration, Brochure, June 1967.

103 C. Decker, Streamlining the Administration of Criminal Justice 12, undated (on file at National Legal Aid and Defender Ass'n, Washington, D.C.).

104 Legal Aid Agency for the District of Columbia, Offender Rehabilitation Project of the Legal Aid Agency for the District of Columbia 6 (unpublished: Second Grant Application, Submitted to the Office of Economic Opportunity, July 1, 1968 through June 30, 1969).

105 *Id.* at 19, 21.

106 STATISTICAL REPORT, *supra* note 35. The executive and legislative branches together employed 10.8 percent of United States' attorneys in 1966. *Id.* at 21.

training course.[107] In Denver, new patrolmen receive 56 hours of training in criminal law and evidence out of a total of 492 hours in their training course.[108] Prison officials and personnel also need to have an overview of the whole criminal justice system as well as detailed knowledge of the law relating to imprisonment.

The general area of social welfare encompasses many occupational groups which must deal with the law. Welfare, social security, and unemployment compensation are obvious examples. For example, few lawyers have examined the badly organized, badly indexed, multi-volume sets of statutes, regulations, and guidelines governing welfare, let alone become as expert as the experienced welfare worker. Generally, welfare workers and administrators have governed the system, with little guidance, or counsel within the agency. Welfare clients have generally been incapable of challenging either the procedure or substance of decisions affecting them. However, in the last few years, some clients have formed local groups of the National Welfare Rights Organization (N.W.R.O.). These groups have studied the regulations and trained welfare clients to represent other clients at administrative fair hearings. In many cases, these paralegal advocates have been embarrassingly successful from the point of view of welfare departments.[109] Perhaps because of a realization that clients were not getting all they deserved under the law, perhaps partially because of the demonstration of inequity by advocates in the N.W.R.O., the Department of Health, Education and Welfare has promulgated requirements that clients be afforded free representation by counsel at administrative fair hearings beginning October 1, 1969.[110] The H.E.W. program will also increase funding to legal aid to provide services for former, present, and potential welfare recipients.[111]

In the legislative branch of the government, the need for paralegals, expert in the drafting of legislation and doing research in the content and effect of past legislation, is imperative. Lawmakers simply do not have time to do the extensive research needed to do a thorough job and cannot rely on their own knowledge, even though many of them are lawyers. States such as California lead in providing assistants for each state legislator.

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107 Decker, *supra* note 103, at 9.

108 Conversation with Lt. E.T. Ruby, Denver Police Academy, in Denver, Colorado, May, 1969.

109 Interview with Alfred A. Fothergill, Institute for Regional Development, Ohio University, Athens, Ohio, in Denver, Colorado, April, 1969.

110 Robb, *supra* note 2, at 347, citing 45 C.F.R. § 205.10 (1969).

111 Robb, *supra* note 2, at 347.

One of the greatest needs of the poor may be to gain access to, and representation in, the decision making processes of legislative and administrative bodies.[112] Those agencies are responsive to the persuasion of well-documented arguments prepared with the assistance of well-financed groups, and to pressure from large voting blocs. The poor have little access to money, but they have sufficient numbers to form a potentially potent voting force. Legal aid offices will often use neighborhood representatives and paralegals to organize the poor community into a cohesive political bloc which can demand and receive in the legislative processes.

Abstracting and title insurance companies are other outstanding examples of how laymen can sometimes do as good a legal job as lawyers.[113] The TransAmerica Company in Denver employs about ten non-lawyers to each lawyer, abstracting and searching titles in real estate transactions. Law school dropouts have been a large source of abstracters, but now demand is exceeding supply even for the dropouts. The title examiner or abstracter has an important and difficult job, but few lawyers engage in this task because the big plant insurers are able to do it as efficiently and with less expense by using non-lawyers.[114]

Real estate brokers have established the right in Colorado to practice law in a narrowly confined area relevant to real estate transactions. The Colorado Supreme Court has held that "*the preparation of receipts and options, deeds, promissory notes, deeds of trust, mortgages, releases of encumbrances, leases, notice terminating tenancies, demands to pay rent or vacate by completing standard and approved printed forms, coupled with the giving of explanation or advice as to the legal effect thereof*"[115] does constitute the practice of law, but permitted real estate brokers to prepare these documents "*in the regular course of their business . . . at the requests of their customers and only in connection with transactions involving sales of real estate, loans on real estate or the leasing of real estate which transactions are being handled by them.*"[116]

Insurance salesmen and claim adjusters are two examples of the paralegal in the insurance business. Insurance salesmen attend extensive conferences and participate in courses scheduled by the

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[112] *See* Bonfield, *Representation for the Poor in Federal Rulemaking*, 67 MICH. L. REV. 511 (1969). *See also* C. HORSKY, THE WASHINGTON LAWYER (1952).

[113] *See* Q. JOHNSTONE & D. HOPSON, JR., LAWYERS AND THEIR WORK, 273-314 (1967) for description of Chicago Title and Trust Co.

[114] The bar has attempted to limit this work to attorneys. *See e.g.*, Title Guarantee Co. v. Denver Bar Ass'n, 135 Colo. 423, 312 P.2d 1011 (1957).

[115] Conway-Bogue Realty Investment Co. v. Denver Bar Ass'n, 135 Colo. 398, 411, 312 P.2d 998, 1004 (1957).

[116] *Id.* at 413, 312 P.2d at 1006.

Chartered Life Underwriters.[117] Instructors for these courses have insurance or other business training and experience and often have law degrees. The courses are taught on a college level and the C.L.U. degree is granted upon the successful completion of the 5-part program and examinations. Undoubtedly, some of those working in life insurance and taking these courses are as well qualified to advise on certain aspects of the law concerning their specialty as is the average lawyer.

Adjusters settle far more insurance claims than do lawyers. They investigate, evaluate, and negotiate the vast bulk of bodily injury claims, and virtually all property damage claims.[118] Adjusters' personal and job characteristics show some common differences between paralegals and lawyers. Adjusters are generally from a lower socio-economic class; have lower academic standing, although most finish college; and tend to fall into the job rather than plan and prepare for it for many years. They are involved in a role conflict because they must obtain releases for their employers, while at the same time, they seek the independent status of professionals who feel ethical restrictions against being unfair to the client.[119] Thus, while the lawyer is a full advocate avoiding all conflicts of interest, the adjuster must balance his company's interest in profit against his conscience and the interest of the insured. While lawyers have a formal code of ethics and disciplinary procedures, the paralegal must operate under far more ambiguous guidelines and conditions.

These differences provide a genuine cause of concern, and the unauthorized practice of law committees have tried to cope with the problems. One of the major questions in paralegal and sublegal training must be how to formulate and enforce ethical rules and disciplinary controls for these occupations. Lawyers are subject to some control from the court and the bar. To whom must the paralegal answer? Some ethical training should be given during their regular training and "treaties" between the bar and some paralegal groups[120] have been fairly successful, but additional solutions must be sought.

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[117] Central administrative offices and the campus of the American College of Life Underwriters are at Bryn Mawr, Pennsylvania; but courses are offered throughout the country. In 1968-1969, at the Colorado University Denver Center, courses were offered on Group Insurance, Health Insurance, and Pensions I; Group Insurance, Health Insurance and Pensions II; Law, Trusts, and Taxation; Business Insurance and Estate Planning; and Estate Planning.

[118] H. ROSS. SETTLED OUT OF COURT, ch. 2. *Insurance Adjusters* (to be published by Aldine Pub. Co. in 1970).

[119] *Id.*

[120] *See* MARTINDALE-HUBBELL, 3 MARTINDALE-HUBBELL LAW DIRECTORY, 215A (1969).

Tax law is lucrative both for the lawyer and for the non-lawyer. The median income of highly specialized tax lawyers in Colorado in 1967 was $16,000.[121] Yet the vast bulk of tax filings and returns are prepared by non-lawyers. Certified public accountants are often more qualified than the nontax lawyer, and can more easily prepare the returns than an attorney. One need only look in the Yellow Pages of the telephone book to find a great many commercial enterprises willing to aid individuals or businesses in preparing tax returns.

The above elaboration of occupations is by no means all inclusive. Yet it does show that no law school will be able to teach members of all occupational groups who need legal training. The question is whether law schools or lawyers will teach *anyone* other than law students and lawyers.

III. Past Paralegal Training at the University of Denver

The concern of the University of Denver College of Law with paralegal and sublegal training grew out of a 1966 conference of leading legal and social educators and administrators concerning "Various Legal Roles." The participants concluded, in part, that "the law has taken the path of ignoring, to a large extent, the problems of training and qualifying people for occupations auxiliary to the law, in spite of overwhelming evidence of the interdependence and co-operation necessary for efficient operation in any profession."[122] This conference was the beginning of an extensive program at the University of Denver College of Law to provide paralegals with a basic knowledge of our system of law and to encourage more extensive use of paralegal services. An ultimate goal was established to train paralegal personnel to function in co-operation with legal specialists, forming legal teams after the long-established practice of specialty teams in the medical profession.

The law school in conjunction with the University of Denver Department of Political Science, prepared a training institute for command officers of the Denver Police Department during the summer of 1968. Senior police officers were given training in the legal and sociological context of their work.

In the fall of 1968, law students were called upon to teach a 20-hour paralegal course to 20 housing specialists at the Metro Denver Fair Housing Center. The participants in the class were of varied educational backgrounds; most had completed high school

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121 ECONOMIC SURVEY, *supra* note 54, at 5.

122 Summary paper on Paralegal Programs of the University of Denver College of Law, fall 1968 (unpublished paper on file with University of Denver College of Law, Administration of Justice Program).

and a few had some college education. The housing workers were instructed in those areas of the law having the most immediate impact upon their clients, including housing, consumer problems, welfare, employment, domestic relations, and criminal law. The evaluative comments of the observing attorney are revealing.

> The goals of the course as designed seemed to be threefold; (1) provide the class with an overview of the areas of the law with which they were most likely to be concerned, (2) create an awareness on the part of the class of potential legal problems, and (3) equip the class with enough understanding of the law in their special area of interest that they could render advice to their clients. This third goal was not designed to encourage the unauthorized practice of law. It was designed to train those working directly with the poor to help the poor understand their rights and duties under the law to the same degree most middle class laymen understand their rights and duties.
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> One of the age-old fears of lawyers about teaching bits of law to laymen is that the layman will suddenly imagine himself competent to render legal advice. The subject questionnaire confirms my belief that this fear is unfounded. When the class was asked how they saw themselves using their new knowledge of the law, the most common response was that the law seems more complex than they had realized. They indicated that the use of their knowledge would probably be in identifying legal problems and advising people to consult a lawyer. The paralegal students repeatedly described their role as a "liaison between lawyer and client."[123]

The College of Law has become deeply involved in the Denver Model City Program. Beginning with the planning year when residents formed committees to outline different problems and possible solutions to those problems, the College of Law, under the direction of Professor Alan Merson, assigned law students as advisors to each of the resident committees. Over the year, these students have given the residents a substantial amount of "on-the-job" paralegal training. The passage of the Community Development Consortium[124] means that the College of Law will be involved in extensive and formal paralegal training for the staff and residents of the Denver Model Neighborhoods.

The College of Law, in May 1969, offered a 25-hour paralegal course to 20 caseworkers from the Denver Department of Welfare. An 80-page curriculum outline of the law in relevant areas was prepared.[125] Law students, law professors, and local attorneys taught the course and a local VISTA lawyer sat in on all classes in order to

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[123] J. Houtchens, Paralegal Training for Metro Denver Fair Housing, Dec. 11, 1968 (unpublished memorandum on file at University of Denver College of Law, Administration of Justice Program).

[124] DENVER, COLO., ORDINANCES §§ 178, 358, series of 1969.

[125] Paralegal Training in Poverty Law, Mar. 1969 (unpublished paper on file at University of Denver College of Law).

evaluate the course and to ask and stimulate questions. Television equipment was used to video-tape the class session as an aid for the improvement of teaching techniques. The course goal was to provide caseworkers with the legal background necessary for more expert guidance of their clients.

IV. Research to Improve Future Sublegal and Paralegal Training

A. *Priorities: What and Why*

Research must center on the problems of the poor. The College of Law's ties to the Model City Program, and the lack of resources of the poor to solve their own problems provide incentives for a concentration of effort on behalf of the poor. For this purpose, the poor need not be defined in the same way as legal aid defines the term. Indeed, those who are just above the income eligibility limits for legal aid are certainly "poorer" when considering their ability to obtain legal services than are those just below those limits; those just below the poverty line are completely subsidized while those just above receive no subsidy. It might be argued that the "all or nothing" formulation of legal aid is unfair and should be changed.

B. *Research Concerning Sublegals*

The success of sublegal training depends upon a correct definition of the scope of legal tasks or operations that can be performed by the sublegal, and which will provide incentive for the lawyer to hire him. It may be that the training should be directed primarily at those already employed by the profession, for example, upgrading the training of the present legal secretaries. Perhaps then, the routine tasks presently performed by the legal secretary could be accomplished by the presently unemployable, after a minimum amount of training.

Thus, one of the most important projects will be to study individuals already working under lawyers' direction. The sublegal's general educational background must be known, as well as the quantity and quality of his legal training. Of importance are the specific tasks he presently performs, whether he is given work primarily as a clerk and typist, or whether he is given work that requires legal thinking and legal training. A time study has been published on legal aid attorneys.[126] However, sublegal help was not directly studied.

The feasibility of employing sublegals depends not only upon the quality and quantity of those competing for the jobs, but also

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[126] PARAPROFESSIONALS, *supra* note 10, at 37.

upon economic factors within the legal profession. For sublegals to be used, even after ethical problems have been resolved, a lawyer must have enough business to make it profitable to hire a sublegal. The advent of an effective plan to settle automobile claims without attorneys, as is visualized in the Keeton-O'Connell plan,[127] could lead to more effective use of a lawyer's time or could result in unemployment of many lawyers. The resulting economic pressure on lawyers, and the pressure on law schools to retrain the lawyers rather than training paralegals and sublegals could postpone the implementation of the paralegal and sublegal concepts for many years. It is possible that a prerequisite to successful entry of sublegals into law offices is a change in the lawyers' availability to the public. A more efficient lawyer referral service, increased efforts to educate individuals as to their needs and of the ability of lawyers to serve them, or further modifications of the ethical prohibitions against solicitation and corporate practice, may be prerequisites to lawyers' hiring sublegals.[128]

If, as we expect, there is enough demand for legal help to create the need for sublegals, then, analysis of the nature of these jobs is necessary in order to create and define *occupations* for the sublegals. An example of a sublegal job and its development might be as follows: a researcher and a number of lawyers specializing in personal injury would discuss the procedures for developing personal injury files. The researcher would become familiar with, collect samples of, and possibly standardize the contracts for contingency fees, the form letters used in getting copies of the records and bills necessary for special damages claims, and the preferred formats for complaints. He would also gather information about interviewing and investigation techniques. After his investigation, the researcher would train students in this particular area of the law. The training would emphasize work as performed in law offices. The texts would include copies and explanations of the forms used in the various offices. Training would include a detailed study of the concept of negligence and its application, and possibly, a study of civil procedure.

At some early stage, perhaps as soon as the student begins his sublegal training, he would start to work for his post-training employer, starting, perhaps, as a file clerk and typist. As the student gained competence, he could do preliminary interviews, gather information for the file, and write drafts of letters and complaints. As part of his further training, the student might be taught tech-

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[127] R. KEETON & J. O'CONNELL, BASIC PROTECTION FOR THE TRAFFIC VICTIM; A BLUEPRINT FOR REFORMING AUTOMOBILE INSURANCE (1965).

[128] *See generally* Llewellyn, *supra* note 3.

niques of negotiation, and informed about the recoveries one might expect from certain sets of factual situations. At this stage, the student could begin to work more closely with the attorney, handling the major part of most cases which might be settled out of court. The attorney could thus devote his time either to trying cases, diversifying his practice into other areas, or supervising a number of sublegals.

The work inspired by Frank Reissman and Arthur Pearl, generally known as "New Careers,"[129] is instructive; those interested in sublegal training, like those implementing the concept of New Careers, are interested in training undereducated and underemployed people to perform socially useful, semi-professional work. Hopefully, following the pattern established by New Careers, at the same time the training for sublegal careers is begun, career advancement "ladders" will be established which will eventually enable trainees to become full-fledged professionals. However, the training for lawyers is so long and rigorous, and the structure of the profession is such that building a career ladder all the way up to full attorney status can only be a long-range goal.

To the extent that New Careers is a success, it should be adopted by those working in sublegal and paralegal areas. Those who have worked with New Careers should possess an experienced knowledge base of how to teach the underemployed and poorly educated. They should have information on the ability of the students to learn new skills, and also on the job market for trainees. To the extent that New Careers training has failed it should signal problem areas that must be examined.

C. *Research Concerning Paralegals*

Paralegal occupations must be studied in much the same fashion that sublegal occupations have been studied. Those nonlegal fields which are particularly relevant to the environment of the poor, or are particularly susceptible to occupational entry by the poor, must be discovered and defined. More knowledge must be gathered about the person who is presently performing the paralegal function. What is his general and legal training? How much of his day does he spend doing legal work? What areas of the law does he need to know in order to do that work? What qualifications are needed to enter that job? What on-the-job training is given now?

Another series of questions relates to the quality of the work presently being accomplished by paralegal personnel. Is the paralegal satisfied with his work? Is the supervisor satisfied with the

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[129] PEARL & RIESSMAN, *supra* note 90.

quality of the work? What does the supervisor, the paralegal, or the client want the paralegal to know more about?

Of course, the need for workers in the particular paralegal area is vital. Is the pay high? Is the turnover high? Does the agency or company have to advertise and give special benefits to those who begin work? Would the agency or company be willing to pay to have their present or future workers trained in the law?

We might find, for example, that there was a great need for Negro and Mexican-American insurance claims adjusters to work in their respective communities. If a sublegal personal injury course and a paralegal insurance adjusters course were both developed, much of the training would be applicable to both. Interviewing and investigative techniques would be taught. There would be instruction in the methods of negotiation and the amount of damages payable under certain circumstances. The focus of the training would be on the concept of negligence, especially as applied to automobile, property, and personal injury litigation and negotiation.

D. *Teaching Techniques*

A final area of our study must be concerned with the methods of teaching. Law schools have typically avoided using teaching assistants, even at the cost of having classes of 100 or more students. But for paralegal training, team-teaching by a number of advanced law students may be more effective than traditional law teaching. Students may be perfectly competent to teach the basic elements of a small area of law. The law student may be a more motivated teacher and engender more enthusiasm in his class. In other cases, it may be lawyers from the community who would be the best teachers, especially for the sublegals. In any event, an evaluation is necessary to decide who would make the best teacher in each particular set of circumstances.

Typical classroom techniques may not always be the best approach for all areas of legal training. For example, civil procedure might be taught by presenting a mock trial, in which students would interrupt to ask questions. Probably much or most of the training should take place on the job. Many of the necessary skills could be taught by practice in the environment where peculiarities of the procedures and personalities within the office can be assimilated. The variety of the post-training jobs is likely to be so great that classes will not be able to cover all the skills needed on any particular job. Research should indicate the amount and type of on-the-job training required.

Programmed teaching may be especially effective with undereducated students, who too seldom receive positive reinforcement for their efforts in school. The students may be more easily motivated by a text which gives them encouragement as they answer questions correctly. Also, this may be a possible entry for programmed teaching into the general law curriculum. The basis of programmed teaching is the same as the traditional Socratic method, and it may be that in teaching only the more elementary concepts of a field of law, there is an advantage over the much larger task of writing programmed texts for a whole area of law.[130]

SUMMARY

One way to meet the increasing demand for legal services is through increased sublegal and paralegal training within law schools. Research indicates the continuing growth of a demand for legal services at a faster rate than the profession, as presently structured, can accommodate. Population growth, urban concentration, and increased education and wealth all put great pressure on the legal profession. Because most legal work must be performed by people rather than machines, the profession must search for cheaper labor. There are many potential trainees, if the legal profession will train and rely on sublegals and paralegals.

In many ways the medical profession has responded more wisely than the law to increased needs. Medicine has provided for extensive training and certification of aides and allied professionals. The legal profession has attempted to monopolize the provision of legal services through the concept of unauthorized practice of law. The law has been slower to adopt new technology, supervised specialization, or subprofessionals. As a result, paralegal jobs have developed with largely unsupervised, and sometimes unprincipled, non-lawyers doing legal work.

A great many sublegal and paralegal jobs are being performed. A few of them have been very efficiently organized while many are probably haphazardly organized. Clearly the field is too large for any one university to organize. More research is needed. The present structure and content of sublegal and paralegal occupations must be determined. Jobs must be subdivided, standardized, specialized, and performed on a mass production basis. Procedures, forms, and checklists must be prepared for curricula designed to teach nonlawyers how to do the greater part of many legal tasks. Research should indicate how long training will have to be, and how it should be distributed between classroom, or similar training, and on-the-job

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130 Healy, Freeman & Hartley, *Programmed Instruction, Teaching Machines and Their Possible Uses in Teaching Law*, 8 J. THE SOC'Y OF PUB. TEACHERS OF L. 275 (1965).

training. Especially, insofar as we are involved in teaching under-educated people, research is needed to devise and choose the most effective teaching methods.

APPENDIX

WARNING
INTERVIEWERS MAY NOT GIVE ANY LEGAL ADVICE

LEGAL NEEDS OF POOR STUDY
UNIVERSITY OF DENVER COLLEGE OF LAW[131]

HELLO, I'M____________________. THE LAW SCHOOL AT THE UNIVERSITY OF DENVER IS TRYING TO FIND OUT ABOUT THE LEGAL NEEDS OF PEOPLE LIVING IN THIS CITY. WE'D APPRECIATE IT VERY MUCH IF YOU WOULD ANSWER A FEW QUESTIONS. THE INFORMATION YOU GIVE WILL BE KEPT COMPLETELY SECRET: THE POLICE, THE WELFARE PEOPLE — NOBODY CAN SEE ANY OF THIS INFORMATION EXCEPT SOME PEOPLE AT THE UNIVERSITY OF DENVER. WE DO NOT EVEN WANT TO KNOW YOUR NAME. ALL WE WOULD LIKE TO KNOW IS SOMETHING ABOUT YOU AND ANY LEGAL PROBLEMS YOU MIGHT HAVE RUN INTO SO THAT WE CAN FIND THE BEST WAY OF GETTING LEGAL HELP TO PEOPLE IN DENVER WHEN THEY NEED IT.

*(If respondent asks why he was chosen)

YOUR HOUSEHOLD WAS JUST PICKED OUT OF A HAT. WE HAVE TO TAKE ADDRESSES THAT WAY SO WE CAN SEE WHAT A WHOLE NEIGHBORHOOD IS LIKE. YOUR HOUSE CAME UP JUST BY CHANCE.

WE WOULD APPRECIATE IT IF WE COULD SPEAK WITH THE HEAD OF YOUR HOUSEHOLD.

(1) FIRST, I WOULD LIKE TO ASK YOU IF YOU FEEL THAT YOU OR ANY MEMBER OF YOUR FAMILY HAS NEEDED LEGAL ADVICE OR A LAWYER IN THE LAST FIVE YEARS?
______Yes ______No

*(If respondent answers "yes," ask)

(2) WHAT WAS THAT ABOUT? Person________ Issue________

*(Persons: e.g., respondent, spouse, father, mother, etc.)

(3) ARE YOU OR ANY MEMBERS OF YOUR FAMILY DEALING WITH A LAWYER NOW? ______Yes ______No
Person______________ Issue______________

(4) HAVE YOU, OR ANY MEMBERS OF YOUR FAMILY, TALKED WITH A LAWYER IN THE LAST FIVE YEARS?
______Yes ______No

*(If "yes," ask)

(5) WHICH MEMBERS OF YOUR FAMILY TALKED TO A LAWYER? Person__________________________

[131] The questionnaire was the basic instrument used in Professor Sykes' study. Legal problems were identified by submitting the answered questionnaire forms to a panel of qualified attorneys. As a possible format for a legal checkup, it is an illustration of a legal service which is not presently provided for within the resources of the legal profession. Although the questionnaire has been renumbered and changed slightly as to form, all of the questions are reproduced.

(6) WHY DID YOU (or he, she) GO TO THE LAWYER?

(7) DID YOU GET A FAIR DEAL FROM THE LAWYER?
______Yes ______No

*(If "no," ask)

(8) WHAT HAPPENED? (Probes: cost too much, no results, he didn't care, didn't try).

(9) HOW DID THE PROBLEM TURN OUT?

(10) WHAT MONTH DID YOU (or he, she) FIRST GO SEE THE LAWYER? Month______ Year______

(11) HOW MUCH DID IT COST ALTOGETHER TO HAVE THE LAWYER? $____________

*(If respondent replied "no" to question 4 (i.e., did not have lawyer), but replied "yes" to question 1 (i.e., felt they needed a lawyer or leagl advice) ask)

(12) YOU SAID BEFORE YOU THOUGHT YOU NEEDED LEGAL ADVICE, BUT YOU DIDN'T GO TO A LAWYER — WHY IS THAT? (Probes: cost, didn't think it would help, don't trust them, etc.).

(13) DID YOU OR ANYONE ELSE IN YOUR FAMILY SEE ANYBODY ELSE ABOUT A LEGAL PROBLEM IN THE LAST FIVE YEARS? ______Yes ______No

*(If "yes," specify below)

(14) WHAT MEMBER OF YOUR FAMILY? Family member________
______________ saw________________

(15) WHO DID YOU (or he, she) SEE? Family member__________
______________ saw________________

NOW I WOULD LIKE TO ASK YOU SOME QUESTIONS ABOUT THINGS YOU MAY OR MAY NOT HAVE BOUGHT IN DENVER IN THE LAST FIVE YEARS. SOMETIMES THERE ARE LEGAL PROBLEMS ABOUT THE THINGS PEOPLE BUY AND THAT IS WHY I WANT TO ASK THESE QUESTIONS.

(16) HAVE YOU OR ANY MEMBER OF YOUR FAMILY BOUGHT SOMETHING IN DENVER AND GOTTEN GYPPED IN THE LAST FIVE YEARS? ______Yes ______No

*(If "yes," ask the following)

(17) WHICH FAMILY MEMBER?

(18) WHAT DID YOU (or he, she) BUY?

(19) HOW MUCH DID IT COST ALTOGETHER? (Total) $______

(20) WHO DID YOU (or he, she) BUY IT FROM?
____Peddler (door-to-door)
____Friend, acquaintance
____Neighborhood store
____Downtown store
____Discount store (neighborhood)
____Discount store not in neighborhood
____Chain store (neighborhood)
____Chain store not in neighborhood
____Other (specify)

(21) WHAT WAS WRONG WITH IT?

(22) DID YOU TRY TO GET YOUR MONEY BACK? __Yes __No

(23) (If "yes") WHAT DID YOU DO?

(24) THEN WHAT HAPPENED?

(25) HAVE YOU OR ANYONE IN YOUR FAMILY BOUGHT SOMETHING ON CREDIT IN THE LAST FIVE YEARS, HERE IN DENVER, AND THEN LOST IT BECAUSE YOU COULDN'T MAKE THE PAYMENTS? _____Yes _____No

*(If "yes," ask the following)

(26) WHAT FAMILY MEMBER BOUGHT IT?
Family member_________________ Item_________________

(27) WHAT DID YOU (or he, she) BUY?

(28) DID YOU (or he, she) PAY ANYTHING DOWN?

(29) HOW MUCH WERE THE PAYMENTS EACH MONTH?

(30) HOW MANY PAYMENTS HAD YOU MADE WHEN THEY CAME AND GOT IT? (Record below)

Down Paym't Amount_____________	Amt. of Monthly Payment_____________	No. of Paym'ts Made_____________

(31) WHO CAME AND GOT IT?

(32) DID THEY TAKE ANYTHING ELSE? _____Yes _____No
(If yes, specify)

(33) DID YOU STILL HAVE TO PAY MORE MONEY AFTER THEY TOOK IT BACK? _____Yes _____No

*(If "yes," ask) HOW MUCH DID YOU STILL HAVE TO PAY ALTOGETHER?

(34) (Total Amount, *after* repossession) $___________.

(35) DID YOU GET A PAPER TO GO TO COURT ABOUT THIS EXTRA MONEY? _____Yes _____No

(36) DID YOU TALK TO A LAWYER ABOUT THE COURT PAPERS? _____Yes _____No

(37) DID YOU TALK TO ANYBODY ELSE ABOUT THE COURT PAPERS? _____Yes _____No

(38) DID YOU GO TO COURT? _____Yes _____No

*(If respondent answers "yes," ask)

(39) WHAT HAPPENED IN COURT?

(40) HAVE YOU, OR ANY MEMBERS OF YOUR FAMILY, LOANED MONEY TO SOMEONE IN DENVER IN THE LAST FIVE YEARS, AND THEN NOT BEEN ABLE TO GET IT BACK? _____Yes _____No

(41) WHICH MEMBERS DID? Family member_________________
Total Amt._________________

(42) HOW MUCH WAS LOANED? Family member_________________
Total Amt._________________

(43) WHO WAS THE MONEY LOANED TO?
(Check one) _____Friend _____Relative _____Other (specify)

(44) DID YOU GET ANYTHING IN WRITING ABOUT THE MONEY? _____Yes _____No

(45) DID YOU TRY TO SUE TO GET THE MONEY BACK? _____Yes _____No

*(If "yes")

(46) THEN WHAT HAPPENED?

(47) HAVE YOU OR ANY MEMBERS OF YOUR FAMILY BORROWED MONEY FROM SOMEONE IN THE LAST FIVE YEARS AND NOT BEEN ABLE TO PAY IT BACK? IN THIS QUES-

TION WE JUST WANT TO KNOW ABOUT MONEY, NOT CREDIT OR MORTGAGES — JUST MONEY. ____Yes ____No

*(If "yes," ask: If "no," skip to question 54)

(48) WHICH MEMBER OF YOUR FAMILY BORROWED MONEY?

(49) HOW MUCH MONEY WAS BORROWED?

(50) WHO DID YOU (or he, she) BORROW THE MONEY FROM?
Family Member____________________ Amount $__________
Borrowed From______________________

(51) DID YOU (or he, she) SIGN ANY PAPERS WHEN YOU BORROWED THE MONEY? ____Yes ____No

(52) DID THE OTHER GUY TRY TO SUE YOU? ____Yes ____No

*(If "yes," ask)

(53) THEN WHAT HAPPENED?

THERE ARE A LOT OF LEGAL PROBLEMS THAT PEOPLE CAN HAVE IN CONNECTION WITH THEIR JOBS. I WOULD LIKE TO ASK YOU ABOUT YOUR JOBS HERE IN DENVER IN THE LAST FIVE YEARS.

(54) DID YOU GET HURT ON A JOB HERE IN DENVER IN THE LAST FIVE YEARS? ____Yes ____No

*(If respondent says "no," skip to question 64)

(55) WHICH MEMBER OF YOUR FAMILY WAS HURT? (Specify)

(56) WHAT KIND OF INJURY OR SICKNESS DID YOU (or he, she) GET ON THE JOB?

(57) DID YOU GO TO THE DOCTOR BECAUSE OF IT?
____Yes ____No

(58) DID YOU FILE A CLAIM WITH ANYBODY? ____Yes ____No

*(If "yes," ask)

(59) WHO DID YOU FILE THE CLAIM WITH? (Specify)

(60) DID YOUR BOSS TAKE CARE OF THE DOCTOR'S EXPENSES?
____Yes ____No

*(If "no," ask)

(61) WHO DID PAY THE DOCTOR'S EXPENSES? (Specify)

(62) DID YOU LOSE A JOB IN THE LAST FIVE YEARS BECAUSE YOU WERE HURT, OR DID ANYONE IN YOUR FAMILY?
____Yes ____No

*(If "yes")

(63) WHICH FAMILY MEMBER DID? (Specify)

(64) DID YOU OR ANY MEMBERS OF YOUR FAMILY HAVE A BOSS WHO DIDN'T PAY THE WAGES YOU HAD COMING IN THE LAST FIVE YEARS HERE IN DENVER?
____Yes ____No

*(If "no," skip to question 70)

(65) WHICH MEMBER OF YOUR FAMILY WAS THIS? (Specify)

(66) DID HE EXPLAIN WHY HE WASN'T PAYING THE WAGES?
____Yes ____No (Specify)

(67) WERE THE WAGES GARNISHED? ____Yes ____No

(68) DID YOU OR ANYONE IN YOUR FAMILY LOSE A JOB BECAUSE OF GARNISHED WAGES IN DENVER IN THE LAST FIVE YEARS? ____Yes ____No

*(If "yes," ask)

(69) WHICH MEMBER OF YOUR FAMILY WAS THAT? (Specify)

(70) DID ANYONE IN YOUR FAMILY FILE BANKRUPTCY IN THE LAST FIVE YEARS IN DENVER? ____Yes ____No

(71) WHO WAS THAT? (Specify)

(72) WHY DID YOU (or he, she) DECIDE TO FILE BANKRUPTCY (Probes: garnishment, heavy debts)

(73) HAVE YOU OR ANY MEMBERS OF YOUR FAMILY ASKED FOR UNEMPLOYMENT MONEY IN DENVER DURING THE LAST FIVE YEARS HERE IN DENVER? ____Yes ____No

*(If "no," skip to question 77)

(74) WHO ASKED FOR THEM? (Specify)

(75) DID YOU (or he, she) GET THE UNEMPLOYMENT BENEFITS YOU ASKED FOR? ____Yes ____No

*(If "no," ask)

(76) WHY DIDN'T YOU GET THEM?

(77) NOW I WOULD LIKE TO ASK YOU A FEW QUESTIONS ABOUT YOUR INCOME TAX. WHO MADE OUT YOUR INCOME TAX LAST YEAR? (Check one)

____Respondent	____A friend
____Accountant, tax adviser (private)	____Social Worker
____IRS accountant	____Other (Specify)

(78) (If respondent did not file an income tax return, check here____)

*(If someone other than respondent made out income tax, ask)

(79) DID THEY CHARGE YOU FOR IT? ____Yes ____No

*(If "yes," ask)

(80) HOW MUCH DID THEY CHARGE YOU FOR IT? (Total charge) $________________

MANY PEOPLE IN DENVER HAVE HAD SOME CONTACT WITH POLICE ABOUT DIFFERENT THINGS DURING THE LAST FIVE YEARS. I WOULD LIKE TO ASK YOU A FEW QUESTIONS ABOUT THE KINDS OF CONTACT THAT YOU MAY HAVE HAD WITH THE DENVER POLICE DEPARTMENT IN THE LAST FIVE YEARS.

(81) HAVE YOU OR ANYONE IN YOUR FAMILY CALLED THE POLICE TO ASK THEM FOR HELP DURING THE LAST FIVE YEARS? ____Yes ____No

(82) WHICH FAMILY MEMBER WAS THAT? (Specify)

(83) WHAT DID YOU WANT THE POLICE TO DO?

(84) DID THE POLICE DO WHAT YOU WANTED THEM TO DO? ____Yes ____No

*(If respondent says "no," ask)

(85) DID THEY EXPLAIN WHY THEY WOULDN'T DO WHAT WANTED? ____Yes ____No

(86) WHAT DID THEY SAY?

(87) HOW DID THE POLICE TREAT AND TALK TO YOU OR YOUR FAMILY WHEN THEY CAME?

(88) HAVE THE POLICE GIVEN YOU OR ANY MEMBERS OF YOUR FAMILY A TICKET OR A SUMMONS IN THE LAST FIVE YEARS IN DENVER? (Check one)
____Ticket
____Summons
____NO ticket OR summons

*(If respondent replies "yes," ask, if "no," skip to question 95)

(89) WHAT WAS THE TICKET FOR? Ticket____________
Fair__________ Not Fair__________

(90) DO YOU THINK IT WAS FAIR OR NOT? Ticket__________
Fair__________ Not Fair__________

*(If respondent says ticket was not fair, ask)
WHY DO YOU THINK THE TICKET WAS NOT FAIR?

(91) DID YOU TAKE THE TICKET (or summons) TO COURT AND FIGHT IT? ____Yes ____No

*(If respondent thought ticket wasn't fair, but didn't take it to court, ask)

(92) WHY DIDN'T YOU TRY TO FIGHT IT IF YOU THOUGHT IT WAS NOT FAIR?
(Probes: cost too much; wouldn't do any good; didn't know I could)

(93) DID YOU GET A LAWYER ABOUT THE TICKET?
____ Yes ____No

(94) HOW DID YOU COME OUT IN COURT?

____Acquitted	____Jail
____Fine	____Probation
____Other (Specify)	

(95) HAVE YOU OR ANY MEMBERS OF YOUR HOUSEHOLD BEEN PICKED UP BY THE POLICE IN THE LAST FIVE YEARS IN DENVER? ____Yes ____No

*(If respondent says "yes," ask, if "no," skip to question 100)

(96) WHICH MEMBER OF YOUR FAMILY WAS PICKED UP? (Record below)

(97) DID THEY GO TO COURT? (Record below) ("yes" or "no")

(98) DID THEY HAVE A LAWYER? (Record below) ("yes" or "no")

(99) WAS IT FAIR TO HAVE BEEN PICKED UP, OR NOT FAIR? (Record below) ("yes" or "no")

Family Member Picked Up	Had Lawyer	Went to Court	Fair

(100) HAVE ANY MEMBERS OF YOUR HOUSEHOLD BEEN IN JAIL IN THE LAST FIVE YEARS IN DENVER? ____Yes ____No

*(If "yes," ask, if "no," skip to question 106)

(101) WHICH MEMBERS OF YOUR FAMILY WERE IN JAIL? (Record below)

(102) DID THEY GO TO JAIL BEFORE OR AFTER THEY SAW A JUDGE OR DID THEY SEE A JUDGE AT ALL?
(Record below, with "before" or "after")

Family Member	Before, After Judge	Did Not See Judge

(103) DID YOU (or he, she) HAVE A TRIAL OR NOT? (Record below)

(104) WAS THE TRIAL FAIR OR NOT? (Record below)

Family Member	Trial (yes, no)	Fair (yes, no)

*(If respondent says the trial was not fair, ask)

(105) WHY DO YOU FEEL THAT THE TRIAL WAS NOT FAIR?

NOW I WOULD LIKE TO ASK YOU SOME QUESTIONS ABOUT CARS AND DRIVING.

(106) HAVE YOU OR ANY MEMBER OF YOUR FAMILY BEEN IN A CAR ACCIDENT DURING THE LAST FIVE YEARS?

*(If "yes," ask, if "no," skip to question 121)

(107) DID A POLICEMAN COME AND CHECK THE DAMAGE AT THE TIME OF THE WRECK? ____Yes ____No

(108) WHICH MEMBER OF YOUR FAMILY WAS DRIVING? (Specify)

(109) WHO WAS AT FAULT?
_____Respondent
_____Other driver
_____Other family member (Specify)
_____Person driving other guy's car
_____Other (Specify)

(110) WHO GOT THE TICKET? (Specify)

(111) DID YOU HAVE INSURANCE AT THE TIME OF THE ACCIDENT? __Yes __No __Don't Remember __Other (Specify)

(112) DID THE OTHER GUY HAVE INSURANCE AT THE TIME OF THE ACCIDENT? _____Yes _____No _____I don't know

(113) DID YOU GET YOUR CAR FIXED AFTER THE ACCIDENT?
_____Yes _____No

(114) WHO PAID FOR GETTING YOUR CAR FIXED? (Check one)
_____Respondent _____Other guy
_____Respondent's ins. co. _____Other guy's ins. co.
_____Other (Specify)

(115) DID YOU GO TO A LAWYER ABOUT THE ACCIDENT?
_____Yes _____No

(116) WHAT DID HE SAY ABOUT THE ACCIDENT?

(117) DID YOU SUE THE OTHER GUY TO GET YOUR MONEY?
_____Yes _____No

*(If respondent says "yes," ask)

(118) HOW DID THAT COME OUT?

(119) DID THE OTHER GUY SUE YOU? _____Yes _____No

*(If respondent answers "yes," ask)

(120) HOW DID THAT COME OUT?

(121) HAVE YOU OR ANY MEMBERS OF YOUR FAMILY BEEN HURT IN A CAR ACCIDENT IN ANY WAY IN THE LAST FIVE YEARS? _____Yes _____No

*(If "yes," ask, if "no," skip to question 132)

(122) WHICH MEMBERS OF YOUR FAMILY WERE HURT? (Specify)

(123) WHAT HAPPENED?

(124) WERE YOU DRIVING? _____Yes _____No

(125) DID YOU OR ANY MEMBERS OF YOUR FAMILY GO TO THE DOCTOR OR TO THE HOSPITAL BECAUSE OF THE ACCIDENT? _____Yes _____No

(126) WHO WAS AT FAULT IN THE ACCIDENT?
_____Respondent _____Other guy

(127) WHO PAID THE MEDICAL EXPENSES YOU HAD? (Check one, if necessary make comments)
_____Respondent
_____Other guy
_____Other (Specify)

(128) HOW MUCH WERE THE MEDICAL EXPENSES IN ALL?
(Total Amount) $_______________

(129) WERE THERE ANY LAW SUITS BECAUSE OF THE ACCIDENT? _____Yes _____No

*(If "yes," ask)

(130) WHAT HAPPENED BECAUSE OF THE LAW SUITS?
(Probes: who were parties? Outcome, esp. for respondent)

(131) DID YOU SUE THE OTHER GUY? ____Yes ____No

(132) HAVE YOU OR ANYONE IN YOUR FAMILY HAD YOUR (or their) DRIVER'S LICENSE SUSPENDED OR TAKEN AWAY IN DENVER IN THE LAST FIVE YEARS? ____Yes ____No

*(If "no," skip to question 136)

(133) WHICH PERSON IN YOUR FAMILY WAS THAT? (Specify)

(134) WHY WAS IT TAKEN AWAY?

(135) DID YOU HAVE A LAWYER WITH YOU IN COURT WHEN THE DECISION TO TAKE AWAY YOUR LICENSE WAS MADE? ____Yes ____No ____Did not go to court

ANOTHER PLACE WHERE PEOPLE RUN INTO LEGAL PROBLEMS IS IN THEIR FAMILIES, WITH THINGS LIKE DIVORCE. I WOULD LIKE TO KNOW IF YOU MIGHT HAVE HAD ANY LEGAL PROBLEMS OF THIS KIND DURING THE LAST FIVE YEARS.

(136) ARE YOU?: (Check appropriate items)
____Married ____Divorced ____Remarried
____Single ____Separated ____Widowed

(137) DO YOU HAVE CHILDREN LIVING WITH YOU?
____Yes ____No

(138) HOW MANY BOYS DO YOU HAVE? (Total)________
Age____ Working____ In school____ In school and working____

(139) HOW MANY GIRLS DO YOU HAVE? (Total)________
Age____ Working____ In school____ In school and working____

*(If respondent is a *WOMAN* and is divorced, separated, or widowed, ask the following question, if a *MAN*, skip to question 146)

(140) ARE YOU SUPPOSED TO GET SUPPORT MONEY FOR *YOURSELF OR CHILDREN?* (Check proper items)
____Yes, self ____Yes, children ____No, not for self or children

(141) DO YOU GET YOUR PAYMENTS?
____Always ____Sometimes ____Never
____Usually ____Not very often

(142) IS THE AMOUNT OF YOUR PAYMENTS FAIR?
____Yes ____No ____Ambivalent

*(If respondent replies "no," ask)

(143) WHY DO YOU THINK THE AMOUNT IS NOT FAIR?

(144) CAN YOU DO SOMETHING ABOUT GETTING THE PAYMENTS MORE REGULARLY? __Yes __No __I don't know

(145) HAVE YOU SEEN A LAWYER OR SOME OTHER AUTHORITIES ABOUT GETTING YOUR PAYMENTS MORE REGULARLY? ____Yes ____No

*(If someone other than a lawyer, specify who)

*(If respondent is a MAN and divorced or separated, ask the following)

(146) ARE YOU PAYING SUPPORT FOR A WIFE OR CHILDREN FROM A PREVIOUS MARRIAGE? ____Yes ____No

(147) DID YOU GET A COURT ORDER TO DO THIS?
____Yes ____No

(148) DO YOU THINK THE AMOUNT IS FAIR? ____Yes ____No

*(If respondent answers "no," ask)

(149) DO YOU THINK YOU MIGHT BE ABLE TO GET THEM CHANGED IF YOU SAW A LAWYER AND WENT TO COURT?
____Yes ____No ____I don't know ____I doubt it

(150) HAVE YOU TALKED TO A LAWYER OR SOMEONE ABOUT GETTING THEM CHANGED?
_____Yes_____No (If other person, specify)

(151) AT THE TIME OF THE DIVORCE (separation) PROCEEDINGS DID YOU HAVE A LAWYER? _____Yes _____No

(152) WHO TAKES CARE OF THE CHILDREN?

Person	Number Caring For
_____Respondent	______________
_____Spouse	______________
_____Friend	______________
_____Relative	______________
_____Foster Home	______________
_____Other (Specify)	______________

(153) DID A COURT MAKE THIS DECISION, OR WAS IT SOMETHING THAT YOU DECIDED? _____Yes _____No

(154) DO YOU THINK THIS IS A FAIR ARRANGEMENT?
_____Yes _____No Comments

ANOTHER PLACE WHERE PEOPLE SOMETIMES HAVE LEGAL PROBLEMS IS WITH THEIR HOUSING. I'D LIKE TO ASK YOU SOME QUESTIONS ABOUT HOUSING AND THE PLACES YOU'VE LIVED DURING THE LAST FIVE YEARS.

(155) DO YOU OWN THE PLACE WHERE YOU LIVE OR DO YOU RENT? _____Own _____Rent

(156) DID YOU BUY A HOME IN THE LAST FIVE YEARS?
_____Yes _____No

(157) WHEN YOU BOUGHT YOUR HOME, WHO DREW UP THE PAPERS? _____Lawyer _____Real Estate Man _____Other (Specify)

(158) HAVE YOU HAD ANY SERIOUS ARGUMENTS WITH YOUR LANDLORD IN THE LAST FIVE YEARS? _____Yes _____No

*(If "yes," ask, if "no," skip to question 172)

(159) WHAT WAS THE ARGUMENT ABOUT?

(160) HAVE YOU MOVED IN THE LAST FIVE YEARS BECAUSE OF AN ARGUMENT WITH THE LANDLORD?
_____Yes _____No _____Partly for that reason

*(If respondent did move because of an argument, ask the following questions)

(161) DID YOU GET ALL OF YOUR STUFF OUT WHEN YOU MOVED? _____Yes _____No

(162) WHAT DIDN'T YOU GET, AND WHY:

(163) DID YOU GET BACK ANY DEPOSITS THAT YOU HAD MADE? _____Yes _____Some money back _____Got none back
__Didn't make any.

(164) WHY DIDN'T THE LANDLORD GIVE IT BACK?

(165) DID YOU TRY TO GET THE DEPOSITS BACK?
_____Yes _____No

*(If "yes," ask)

(166) WHAT DID YOU DO?

(167) HOW MUCH DID YOU LOSE IN DEPOSIT MONEY?
(Total) $______________

(168) DID YOU TRY TO GET YOUR STUFF BACK? _____Yes _____No

(169) WHAT DID YOU DO TO TRY TO GET IT BACK?

(170) DID ANYTHING ELSE HAPPEN AFTER THE ARGUMENT? (If "yes," specify)

(171) HOW WAS THE ARGUMENT FINALLY ENDED?

NEXT I WOULD LIKE TO ASK YOU SOME QUESTIONS ABOUT DISCRIMINATION WHICH YOU MIGHT HAVE RUN INTO.

(172) DO YOU FEEL THAT YOU HAVE BEEN DISCRIMINATED AGAINST WHEN YOU TRIED TO BUY OR RENT A HOUSE IN DENVER IN THE LAST FIVE YEARS? ____Yes ____No

*(If respondent answers "yes," ask)

(173) WHAT HAPPENED?

(174) DO YOU THINK YOU OR ANY MEMBERS OF YOUR FAMILY HAVE BEEN DISCRIMINATED AGAINST TRYING TO GET OR KEEP A JOB IN DENVER IN THE LAST FIVE YEARS? ____Yes ____No

*(If "yes," ask)

(175) WHAT HAPPENED?

(176) ARE THERE PLACES IN DENVER YOU STAY AWAY FROM BECAUSE YOU THINK YOU WOULD BE DISCRIMINATED AGAINST? ____Yes ____No

*(If "yes," ask)

(177) WOULD YOU NAME A FEW OF THEM FOR ME?

(178) HAVE YOU TRIED TO VOTE AND NOT BEEN ALLOWED TO IN THE LAST FIVE YEARS, OR HAS ANYONE IN YOUR FAMILY NOT BEEN ALLOWED TO? ____Yes ____No

*(If respondent answers "yes," ask)

(179) WHY WERE YOU NOT ALLOWED TO VOTE?

(180) DID YOU VOTE IN THE LAST ELECTION FOR PRESIDENT? ____Yes ____No

(181) HAVE YOU VOTED SINCE THEN? ____Yes ____No

(182) HAVE YOU BEEN DISCRIMINATED AGAINST IN ANY WAY WHICH WE HAVE NOT COVERED? ____Yes ____No
Comments

(183) HAVE YOU OR ANY MEMBERS OF YOUR FAMILY COMPLAINED ABOUT DISCRIMINATION TO ANYONE IN DENVER IN THE LAST FIVE YEARS? ____Yes ____No

*(If "yes," ask)

(184) WHOM DID YOU COMPLAIN TO?

(185) WHAT HAPPENED THEN?

(186) HAVE YOU OR ANY MEMBERS OF YOUR FAMILY ASKED FOR ANY KIND OF CITY, STATE, OR FEDERAL WELFARE HELP WHILE YOU WERE LIVING IN DENVER DURING THE LAST FIVE YEARS? ____Yes ____No

(187) (Specify answer given about not receiving welfare benefits)

(188) DID YOU GET THE HELP YOU ASKED FOR? ____Yes ____No

*(If "no," ask)

(189) WERE YOU TOLD WHY YOU DIDN'T GET THE HELP YOU ASKED FOR?

(190) WHICH FAMILY MEMBER ASKED FOR THESE BENEFITS? (Specify)

(191) WHAT KIND OF HELP WERE YOU ASKING FOR? (Or he, she)
Person____________________Type of Help________________

(192) HOW WERE YOU TREATED BY THE PEOPLE WHERE YOU APPLIED FOR THE MONEY? (Verbatim)

(193) DO YOU THINK YOU HAVE GOTTEN LESS WELFARE MONEY THAN YOU HAD COMING? ____ Yes ____No

*(If "yes," ask)

(194) DO YOU FEEL THAT YOU OR ANY MEMBER OF YOUR FAMILY HAS BEEN TREATED BADLY IN A DENVER HOSPITAL IN THE LAST FIVE YEARS? ____Yes ____No

(195) WOULD YOU TELL ME WHAT HAPPENED? (Probes: social *and* medical aspects)

(196) HAS A CHILD OF YOURS BEEN EXPELLED FROM A DENVER SCHOOL DURING THE LAST FIVE YEARS? ____Yes ____No

*(If respondent answers "yes,' ask, if "no," skip to question 202)

(197) WHAT WAS HE (or she) EXPELLED FOR?

(198) HOW LONG WAS HE (or she) EXPELLED FOR? (Months)______ (Weeks)______ (Days)______

(199) DID HE (or she) GO BACK TO SCHOOL? ____Yes ____No

(200) WAS THE SCHOOL WHICH EXPELLED YOUR CHILD A DENVER PUBLIC SCHOOL OR WAS IT A PAROCHIAL SCHOOL? ____Denver Public ____Parochial School

(201) HOW OLD WAS YOUR CHILD? Years________

I KNOW THIS HAS TAKEN QUITE A BIT OF TIME AND THERE ARE JUST A FEW MORE QUESTIONS I WOULD LIKE TO ASK YOU. I WOULD LIKE TO KNOW SOME THINGS ABOUT YOU AND YOUR FAMILY AND WHAT YOU THINK ABOUT LEGAL PROBLEMS.

(202) (Check sex of respondent: ____Male ____Female

(203) HOW LONG HAVE YOU LIVED IN DENVER? ____Years ____Months

(204) ARE YOU WORKING AT THE PRESENT TIME? ____Yes ____No

*(If respondent says "yes," ask)

(205) WHAT DO YOU DO?

*(If respondent says "no," ask)

(206) HOW LONG HAS IT BEEN SINCE YOU HAVE WORKED? ____Years ____Months ____Weeks ____Days

(207) WHAT KIND OF JOB DID YOU USED TO HAVE?

(208) BESIDES YOURSELF AND YOUR CHILDREN, HOW MANY PEOPLE LIVE IN YOUR HOUSE (apartment) WITH YOU?
Males____ Age____ Females____ Age____
Total____ Total____

(209) HOW FAR DID YOU GO IN SCHOOL?

Grammar School		High School	College
____1	____5	____1	____1
____2	____6	____2	____2
____3	____7	____3	____3
____4	____8	____4	____4

(210) DID YOU GO TO ANY TYPE OF TRADE SCHOOL OR PROFESSIONAL SCHOOL? ____Yes ____No

(211) WHAT KIND OF SCHOOL WAS THAT? Type________ Years________ Months________

(212) HOW OLD ARE YOU? _____ Years _____Months

* (If respondent is married)

(213) WHEN YOU WERE MARRIED DID A MINISTER MARRY YOU, DID A JUDGE MARRY YOU, OR NEITHER?

(214) (Check one) _____Judge _____Minister _____Neither (first time)

(215) _____Judge _____Minister _____Neither (second time)

(216) * (Interviewer, check appropriate ethnic-color group)
_____Negro _____White _____Oriental

(217) I SAID BEFORE THAT WE DON'T NEED TO KNOW YOUR NAME, AND WE DON'T. BUT I WOULD LIKE TO KNOW IF YOU HAVE A SPANISH-AMERICAN NAME? JUST SAY YES OR NO. _____Yes _____No

(218) IT WOULD BE A GREAT HELP TO US TO KNOW HOW MUCH INCOME YOU HAVE EACH WEEK. WOULD YOU PLEASE TELL US ABOUT HOW MUCH MONEY COMES INTO YOUR HOUSEHOLD EACH WEEK, AND WHO BRINGS IT IN.

Respondent_____ Amount $____________(per week)
Spouse _____ Amount $____________(per week)
Child _____ Amount $____________(per week)
Total $ per week $____________
Welfare _____ Amount $____________(per week)
Pensions _____ Amount $____________(per week)

(219) NEXT I AM GOING TO READ OFF SOME THINGS YOU MAY OR MAY NOT OWN. IF YOU OWN THEM PLEASE SAY YES WHEN I READ THEM OFF TO YOU. DO YOU OWN:

_____a car	_____a dishwasher
_____a refrigerator	_____a washing machine
_____a TV set	_____a clothes drier
_____a radio	_____a sewing machine
_____a vacuum cleaner	_____a phonograph

(220) NOW I WOULD LIKE TO KNOW HOW MANY TIMES YOU AND MEMBERS OF YOUR FAMILY HAVE SEEN A DOCTOR AND DENTIST.

	Doctor	Dentist
Respondent	____________	____________
Spouse	____________	____________
Child	____________	____________

NOW WE WOULD LIKE TO KNOW THE BEST WAY OF GETTING INFORMATION ABOUT LEGAL HELP OUT TO PEOPLE. I WOULD LIKE TO KNOW ABOUT THE TV YOU WATCH, THE RADIO SATIONS YOU LISTEN TO, THE NEWSPAPERS YOU READ AND SO ON.

(221) ABOUT HOW MANY HOURS DO YOU AND YOUR FAMILY WATCH TELEVISION PER DAY? (Interviewer, convert this to amount watched per week) _____Respondent _____Spouse _____Children

(222) ABOUT HOW MANY HOURS DO YOU LISTEN TO THE RADIO PER DAY? _____Respondent _____Spouse _____Children

(223) ABOUT HOW MANY TIMES DO YOU READ A NEWSPAPER EACH WEEK?

(224) WHICH NEWSPAPER DO YOU LIKE BEST? (Specify)

(225) WHAT PART OF THE PAPER IS MOST INTERESTING TO YOU?

(226) WHAT CLUBS OR ORGANIZATIONS DO YOU BELONG TO?

_____Church _____PTA
_____Social Club _____Other (Specify)
_____Labor Union _____Other (Specify)

(227) ABOUT HOW OFTEN DO YOU GO TO CHURCH A MONTH?

(228) WHAT CHURCH IS THAT?

(229) WHERE IS IT LOCATED?

(230) I AM GOING TO READ YOU A SHORT LIST OF PLACES WHERE PEOPLE MIGHT GO IF THEY NEEDED LEGAL ADVICE. WOULD YOU TELL ME IF YOU WOULD GO THERE WHEN I READ THE PERSON. SAY YES, NO, OR MAYBE

*(Interviewer, record answer: Y—Yes, N—No, M—Maybe)

_____A minister _____A doctor
_____A friend _____A lawyer
_____A politician _____A relative
_____A social worker

(231) WHICH OF THOSE PEOPLE WOULD YOU GO TO FIRST?

____

(232) DO YOU KNOW IF DENVER HAS A LEGAL AID SOCIETY OR NOT? __Yes __No __Maybe, I'm not sure __I don't know

*(If respondent answers "yes," on last question, ask)

(233) CAN YOU TELL ME WHERE THAT IS?
(If not eractly, approximately)
__Respondent located exactly __Respondent located approximately
__Respondent did not locate it

(234) DO YOU KNOW IF DENVER HAS ANY OTHER WAYS OF GIVING FREE LEGAL HELP TO PEOPLE? _____Yes _____No

*(If respondent says "yes," ask)

(235) WHAT ARE THEY?

(236) WHERE ARE THEY?

(237) HAVE YOU USED ANY OF THOSE PLACES? _____Yes _____No

(238) WHICH ONES DID YOU USE?

(239) WHEN DID YOU USE THEM?

(240) I WOULD LIKE TO ASK ONE MORE QUESTION ABOUT FINANCES. DO YOU OWE MONEY TO ANYBODY NOW FOR THINGS YOU HAVE BOUGHT OR FOR ANY OTHER REASON, LIKE MEDICAL EXPENSES OR SOMETHING LIKE THAT? _____Yes _____No
Item______________________ Amount Owed $_______________
Money owed to_________________Total Owed $___________

THIS IS THE LAST GROUP OF QUESTIONS I WOULD LIKE TO ASK AND THEY WILL TAKE JUST A FEW MINUTES. WE ARE INTERESTED IN KNOWING HOW YOU FEEL ABOUT CERTAIN THINGS PEOPLE THINK ABOUT AND SAY IN A CITY LIKE DENVER. THERE ARE NO RIGHT OR WRONG ANSWERS: THESE ARE STATEMENTS THAT OTHER PEOPLE HAVE MADE AT ONE TIME OR ANOTHER, AND WE WOULD JUST LIKE TO KNOW WHAT YOU THINK, ABOUT THAT KIND OF STATEMENT.

(241) "WHEN I MAKE PLANS HERE IN DENVER, I AM FAIRLY SURE I CAN MAKE THEM WORK." __Definitely Agree __Definitely Disagree __Don't know __Don't care

(242) "THE AVERAGE PERSON CAN INFLUENCE THE WAY THE GOVERNMENT OF DENVER IS RUN."	__Definitely Agree __Don't know	__Definitely Disagree __Don't care
(243) "SOMETIMES I FEEL VERY MUCH ALONE IN MY NEIGHBORHOOD, HERE IN DENVER."	__Definitely Agree __Don't know	__Definitely Disagree __Don't care
(244) "THE WAY THINGS ARE IN A CITY LIKE DENVER TODAY, PEOPLE CAN'T COUNT ON REALLY GETTING TO KNOW EACH OTHER VERY WELL."	__Definitely Agree __Don't know	__Definitely Disagree __Don't care
(245) "BECOMING A SUCCESS HERE IN DENVER IS PRETTY MUCH A MATTER OF HARD WORK: LUCK HAS LITTLE OR NOTHING TO DO WITH IT."	__Definitely Agree __Don't know	__Definitely Disagree __Don't care
(246) "GETTING A GOOD JOB HERE IN DENVER DEPENDS ON BEING IN THE RIGHT PLACE AT THE RIGHT TIME."	__Definitely Agree __Don't know	__Definitely Disagree __Don't care
(247) "PEOPLE LIKE ME CAN'T DO MUCH TO PROTECT OURSELVES AGAINST SOME OF THE BIG ORGANIZATIONS IN DENVER."	__Definitely Agree __Don't know	__Definitely Disagree __Don't care
(248) "WHETHER YOU LIKE IT OR NOT, WHAT GOES ON IN DENVER OR ANY PLACE ELSE IS MOSTLY A MATTER OF LUCK."	__Definitely Agree __Don't know	__Definitely Disagree __Don't care

JUST ANSWER THESE FOUR QUESTIONS BY SAYING "YES," "NO," OR "UNDECIDED."

(249) IF A MEMBER OF YOUR FAMILY HAD COMMITTED A SERIOUS CRIME, WOULD YOU HELP HIM KEEP FROM GETTING CAUGHT?

_____Yes _____No _____Undecided

(250) DO YOU KNOW OF A JUDGE WHO IN YOUR OPINION SHOULD BE REMOVED FROM OFFICE?

_____Yes _____No _____Undecided

(251) IF YOU RECEIVED A LETTER TELLING YOU THAT YOUR REFRIGERATOR WAS ABOUT TO BE REPOSSESSED, WOULD YOU CALL A LAWYER?

_____Yes _____No _____Undecided

(252) IF YOU KNEW SOMEONE WAS GAMBLING NEXT DOOR AND YOU SAW A POLICEMAN COMING, WOULD YOU WARN YOUR NEIGHBOR?

_____Yes _____No _____Undecided

THIS IS THE END OF THE INTERVIEW. THANK YOU VERY MUCH FOR YOUR TIME AND HELP. WE BELIEVE THAT THIS WILL BE OF A GREAT DEAL OF HELP IN KNOWING WAYS TO GET THE RIGHT KIND OF LEGAL INFORMATION TO PEOPLE IN DENVER WHO NEED IT. THANK YOU AGAIN VERY MUCH, YOU HAVE BEEN A VERY BIG HELP.

Name of interviewer____

Address of respondent____

Time of visit____

Date of visit____

STATUS OF INTERVIEW

_____Complete

_____Incomplete

_____Refusal

_____No Contact

Length of Interview____

ADDITIONAL COMMENTS:

THE HIGHWAY BEAUTIFICATION ACT OF 1965: A CASE STUDY IN LEGISLATIVE FRUSTRATION

BY RICHARD D. LAMM* AND STEPHEN K. YASINOW**

A growing national concern with billboards and other forms of visual pollution resulted in the Federal Highway Beautification Act of 1965. This article suggests that the legislation has had little positive effect and may actually work against highway beautification, with two factors combining to tie the hands of those state legislatures that seek to eliminate or reduce the number of billboards on their highways. First, Congress has not appropriated any funds during the last two fiscal years to enable the Federal Government to pay its 75 percent commitment; and second, the "just compensation" provisions of the act directly conflict with the laws of many states, which provide for taking under the police power. Two possible solutions to the problems are suggested: (1) Resort to the courts for clarification of ambiguities in the act; and (2) Amendment of the act by Congress to permit the states to elect their own techniques by which to enforce federal standards.

THE Congress of the United States in the Highway Beautification Act of 1965 declared loftily: "[T]hat the erection and maintenance of outdoor advertising signs, displays, and devices in areas adjacent to the Interstate System and the primary system should be controlled in order to protect the public investment in such highways, to promote the safety and recreational value of public travel, and to preserve natural beauty."[1]

The subsequent history of the Highway Beautification Act indicates these goals have not been realized and that the act which proposed to control billboards serves as the single greatest impediment in many states to passing effective billboard control legislation.[2]

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1 Highway Beautification Act, 23 U.S.C. § 131(a) (1965). Both Houses of Congress expressed an awareness of a national billboard problem. In the Senate, roadside advertising was referred to as "a creeping cancer" which creates "blighted corridors" and makes the nation's highways "a huge and garish want ad." 111 CONG. REC. 23891 (1965) (remarks by Senator Dodd). The House also expressed a strong interest in eradicating "the garish clutter symbolic of a crass commercialism," 111 CONG. REC. 26140 (1965) (remarks by Representative Wright) in order to create scenic corridors, 111 CONG. REC. 26276 (1965) (remarks by Representative Howard).

2 The Colorado Legislative Council made an inquiry of the fifty states. Replies were were received from 37. Some sample replies: "The terrific administrative expense in administering a program meeting the Federal requirements is a doubtful investment on the public's part for the benefits derived therefrom." (Alabama); "The hindrance encountered to date is a lack of participating Federal funds to implement the Federal Act and State Legislation." (Maryland); "[It] has hindered our ability to enforce

The fate of the act serves as an excellent illustration of how the legislative process can be subverted, in that a single section in legislation inserted by a clever lobby or overlooked in the political process can render the legislation inoperative and in effect make it counterproductive.

The Highway Beautification Act of 1965 provides that any state that the Secretary of Transportation determines has not provided for "effective control" of the erection and maintenance of outdoor advertising along the interstate and primary highway system would lose 10 percent of its Federal-Aid Highway allotment.[3] The Secretary is charged with the duty of setting certain national standards concerning the lighting, size, number, and spacing of signs[4] and with setting standards of "customery use" which will allow outdoor advertising in areas adjacent to the interstate and primary system which are "industrial or commercial" either as zoned or when meeting certain standards agreed upon between the Secretary and the individual state.[5]

The act provides that "just compensation" shall be paid for the removal of all outdoor advertising and provides that the states must pay 25 percent of the just compensation, which includes compensation to the owner of the billboard for the taking of his "right, title, leasehold, and interest" in it. In addition, the property owner on whose land the sign is located must be "justly compensated" for the taking of his "right to erect and maintain" the billboard thereon.[6]

The act further stipulates that any billboard which is lawfully in existence on September 1, 1965, and which is illegal under the act (Illegal billboards are defined as signs other than official signs, those which advertise the sale or lease of property, or which advertise activities conducted on the premises.[7]) does not have to be removed until July 1, 1970. All other lawfully erected nonconforming signs are not required to be removed until 5 years after they become nonconforming under the act.[8] The compliance date for states to conform to the Federal Act was set at January 1, 1968.[9] A 1968 amendment

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our 1961 Act, due to the compensation factor and resulting delays occasioned by several court injunctions filed in various Federal courts." (Washington). Legislative Council Survey, Colorado General Assembly, Denver, Colorado, 1969, on file with that agency [hereinafter cited as Survey].

[3] Highway Beautification Act, 23 U.S.C. § 131(b) (1965).

[4] *Id.* § 131(c).

[5] *Id.* § 131(d). A 1968 amendment to this section provides: "Whenever a bonafide State, county or local authority has made a determination of customary [commercial or industrial] use, such determination will be accepted . . . ." Federal-Aid Highway Act, 23 U.S.C. § 131(d) (1968).

[6] Highway Beautification Act, 23 U.S.C. § 131(g) (1965).

[7] *Id.* § 131(c).

[8] *Id.* § 131(e).

[9] *Id.* § 131(c).

declared that no outdoor advertising shall be required to be removed under the act until the federal share of the compensation to be paid is available.[10]

Two factors, both apparently unforeseen by even the sponsors of the Highway Beautification Act, serve to severely tie the hands of any state legislature which seeks to eliminate or reduce the number of billboards on its highways. The first is the fact that no funds were appropriated for 1968 or 1969 fiscal years by Congress to enable the Federal Government to pay its 75 percent commitment.[11]

The second factor is an opinion issued by the United States Attorney General which discusses the "just compensation" provision and declares "that Section 131 is to be read as *requiring* each state to afford their 25 percent share just compensation as a condition of avoiding the 10 percent reduction of subsection (b)."[12]

The effect of the inability or refusal on the part of Congress to fund its 75 percent share combined with the Attorney General's opinion that requires states to pay to take down billboards or risk losing 10 percent of their Federal-Aid Highway funds, has produced state legislative inaction and has had a negative effect on a state's ability to independently seek to control outdoor advertising.[13]

The effects of this impasse are becoming increasingly clear. The outdoor advertising situation reported throughout the United States ranges from "worse than ever" to reports of little change.[14] Only 21 of the 50 states have enacted legislation or taken steps to comply with the federal program and most of these already had effective billboard legislation prior to the act.[15] More serious, states that had legitimated billboard regulation through their police powers were confronted with the possibility of losing their Federal-Aid Highway funds unless they made provision for "just compensation" by amend-

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[10] Federal-Aid Highway Act, 23 U.S.C. § 131(n) (1968).

[11] The N.Y. Times, Aug. 31, 1969, at 42, col. 1. Since questions still exist concerning which areas are commercial and industrial, no valid determination on the costs of "just compensation" nationwide is yet available. However, estimates of the cost of compensating sign proprietors are $558 million. *Id.* at col. 3. In 1968, while considering the Federal-Aid Highway Act of 1968, Senator John Sherman Cooper recognized the fact that "a difficult fiscal situation" had imposed upon Congress "a responsibility to reduce, wherever possible, authorizations as well as appropriations." 3 *United States Code Congressional and Administrative News* 3526 (1968). In light of Senator Cooper's remarks, the authorization of $418.5 million for highway beautification by the Federal Government appears highly unlikely.

[12] Letter from Ramsey Clark, Attorney General, to John T. Connor, Secretary of Commerce, Nov. 16, 1966, on file with Highway department, State of Colorado, Denver, Colorado (emphasis added) [hereinafter cited as Letter].

[13] Survey, *supra* note 2.

[14] The N.Y. Times, Aug. 31, 1969, at 1, col. 2.

[15] Of the 21 presently complying states, 15 had previously enacted strong billboard control legislation. These states are: California, Connecticut, Delaware, Hawaii, Kentucky, Maine, Maryland, Nebraska, New York, Ohio, Pennsylvania, Rhode Island, Vermont, Virginia, and West Virginia. The N.Y. Times, Aug. 31, 1969, at 42, col. 4.

ing their laws.[16] That the remaining states are not in compliance, may reflect frustration or a lack of understanding on the part of many state legislatures as to how to proceed on controlling outdoor advertising.

The jurisdictions which have passed legislation in compliance with the Highway Beautification Act show a great variance on exactly what is "just compensation."[17] Many state laws provide that "just compensation" means the full value of both the right, title, and interest in the sign and in addition compensation to the owner of the property for his right to erect and maintain signs thereon.[18] Others provide for a combination of amortization and compensation.[19] The dissatisfaction with the "just compensation" provision is clear, judging from a number of state laws which provide that compensation shall be paid "only when made mandatory by federal law," and absent such a mandate, removal of billboards must be effected by amortization without compensation.[20] The stilted language of Vermont's law evidences that legislature's frustration at the just compensation provision. The law provides:

> Compensation shall be paid upon the taking or removal of outdoor advertising under this chapter only if, and to the extent federal law, when in effect, requires payment of compensation for the taking or removal of outdoor advertising on state highways as a condition for payment to the state of federal highway funds, and the federal funds are available.[21]

There are many reasons why a state may object to the "just compensation" provision. There would appear to be no federal and, in most states, no state constitutional requirement to pay "just compensation" either to the owner of the sign or to the owner of the

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[16] Records of the Colorado Highway Department reveal that 23 states would have to amend their laws. Records on file with the Highway Department, State of Colorado, Denver, Colorado [hereinafter cited as Records].

[17] Jurisdictions which have instituted regulations conforming with federal standards are: Alaska, California, Connecticut, Delaware, District of Columbia, Hawaii, Iowa, Kentucky, Maine, Maryland, Minnesota, Nebraska, New York, Ohio, Pennsylvania, Puerto Rico, Rhode Island, Utah, Vermont, Virginia, and West Virginia. The N.Y. Times, Aug. 31, 1969, at 42, col. 4.

[18] *See, e.g.*, ARK. STAT. ANN. § 25-2501 (Supp. 1967); MO. REV. STAT. § 226.500 (Supp. 1968); W. VA. CODE § 17-22-5 (1967). *See also* Survey, *supra* note 2.

[19] *See, e.g.*, KY. REV. STAT. § 177.840(3) (1968); N.H. REV. STAT. ANN. ch. 249-A § 11(vi) (1969). The New Hampshire act provides:

> In calculating just compensation to be paid to the owner of an advertising device required to be removed by reason of nonconformity with Section 5 of this chapter . . . it is intended that the five-year period of nonconforming use shall be considered as whole or partial compensation to said owner for his loss. It is further intended that in calculating just compensation to the owner of land for which rental compensation has been paid for the five preceeding years, such rental income during the period of nonconforming use be taken into consideration as whole or partial compensation.

Id. Ch. 249-A § 11. *See also* Survey, *supra* note 2.

[20] *See, e.g.*, ME. REV. STAT. ANN. tit. 32, ch. 38 § 2719(7) (Supp. 1969); VT. STAT. ANN. tit. 10, ch. 14 § 336 (Supp. 1969). *See also* Survey, *supra* note 2.

[21] VT. STAT. ANN. tit. 10, ch. 14 § 336 (Supp. 1969).

land on which the sign is located.[22] Under the Federal Aid Highway Act of 1958, which granted a bonus to states which passed outdoor advertising control, 25 states had passed legislation and signed agreements with the Secretary of Commerce, and of these, 23 chose to use police power rather than eminent domain.[23] Congress, therefore, went against a large and growing body of law when it required payment of "just compensation."[24]

The reasons for the legislative decisions of these 23 states seems clear and are reflected in the various State Supreme Court opinions which upheld "police power" legislation. In *New York Thruway Authority v. Ashley Motor Court* the New York court said:

> [I]t is to be borne in mind that it was the very construction of the Thruway which created the element of value in the land abutting the road. Billboards and other advertising signs are obviously of no use unless there is highway to bring the traveller within view of them. What was taken by the regulation, therefore, was the value which the Thruway itself had added to the land and of this the defendant cannot be heard to complain.[25]

In *Ghaster Properties, Inc. v. Preston,* the Ohio Supreme Court said:

> In the instant case, the statutes only deprive an owner of a claimed right to use his land to communicate with those using the highway . . . . [A]ny such right to so communicate can be taken from the landowner without compensation by the state for the purpose of improving the highway as a means of passage for the public.[26]

The Supreme Court of Vermont, upholding general billboard regulation, in *Kelbro, Inc. v. Myrick,* quoted with approval from an earlier case, saying:

> It is obvious that something more is claimed than the mere right to erect and maintain bill-board structures upon lands adjacent to the highway. In its essence the right that is claimed is to use the public highway for the purpose of displaying advertising matter. This fact has been well stated by the Philippine Supreme Court which said that "the success of bill-board advertising depends not so much upon the use of private property as it does upon the use of the channels of travel by the general public. Suppose that the owner of private property — should require the advertiser to paste his posters upon the billboards so that they would face the interior of the property instead of the exterior. Bill-board advertising would die a natural death if this were done, and its real dependency not

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[22] Euclid v. Amber Realty Co., 272 U.S. 365 (1926); St. Louis Poster Advertising Co. v. City of St. Louis, 249 U.S. 269 (1919); Thomas Cusack Co. v. City of Chicago. 242 U.S. 526 (1917); St. Louis Gunning Advertising Co. v. City of St. Louis, 235 Mo. 99, 137 S.W. 929 (1911), *appeal dismissed,* 231 U.S. 761 (1913); New York Thruway Authority v. Ashley Motor Court, Inc., 10 N.Y.2d 151, 176 N.E.2d 566, 218 N.Y.S.2d 640 (1961); Ghaster Properties, Inc. v. Preston, 176 Ohio St. 425, 200 N.E.2d 328 (1964).

[23] Records, *supra* note 16.

[24] Highway Beautification Act, 23 U.S.C. § 131(g) (1965).

[25] 10 N.Y.2d 151, 176 N.E.2d 566, 569, 218 N.Y.S.2d 640, 644 (1961).

[26] 176 Ohio St. 425, 200 N.E.2d 328, 333 (1964).

upon the unrestricted use of private property but upon the unrestricted use of the public highways is at once apparent. Ostensibly located on private property, the real and sole value of the billboard is its proximity to the public thoroughfares. Hence, we conceive that the regulation of billboards and their restriction is not so much a regulation of private property as it is a regulation of the use of the streets and other public thoroughfares."[27]

The Massachusetts Supreme Court, in *General Outdoor Advertising Co. v. Dept. of Public Works,* had this to say about the right of private property:

> The right asserted is not to own and use land or property to live, to work, or to trade. While it may comprehend some of these fundamental liberties, its main feature is the superadded claim to use private land as a vantage ground from which to obtrude upon all the public traveling upon highways, whether indifferent, reluctant, hostile or interested, an unescapable propaganda concerning private business with the ultimate design of promoting patronage of those advertising. Without this superadded claim, the other rights would have no utility in this connection.[28]

Congress in requiring "just compensation," then, apparently made its own legislative determination, and rejected the police power approach taken by the vast majority of state outdoor advertising legislation.[29] In doing so it not only undercut the well established practice of regulating outdoor advertising through the police power, but also raised two questions: first, what is "just compensation"; and second, can the Federal Government constitutionally dictate not only the substantive end results, but also the procedural means by which roadside beautification is to be achieved?

A study of the legislative history of the act shows that the declared effect of the *just* compensation provision might be far different than that which Congress intended. The Administration bill on highway beautification which was introduced into Congress in May of 1965, authorized the use of state police power, not eminent domain, for effecting the control of outdoor advertising.[30] But the Committee on Public Works in the Senate amended the bill to require "just compensation."[31] It was explained that it was because the act was to apply to the primary road system as well as to the interstate,

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[27] 113 Vt. 64, 30 A.2d 527, 529 (1943), *quoting from* Churchill *et al.* v. Rafferty, 32 P.I. 580, 609, *appeal dismissed,* 248 U.S. 591 (1918).

[28] 289 Mass. 149, 193 N.E. 799, 808, *appeal dismissed,* 296 U.S. 543 (1935), *appeal dismissed,* 297 U.S. 725 (1936).

[29] Representative Thomas Pelly remarked during the 1965 beautification bill debates, that 36 states were already able to regulate outdoor advertising by use of their police powers. 111 CONG. REC. 26306 (1965) (remarks by Representative Pelly). This statement is consistent with the fact that 23 police power states *had signed agreements* with the Secretary of Commerce under the 1958 Highway Act. Records, *supra* note 16.

[30] 111 CONG. REC. 23797 (1965) (remarks by Senator Cooper).

[31] *Id.*

and to the billboard industry and small businesses which had advertised and developed with the primary roads for more than 40 years, that compensation should be paid,[32] even though it was acknowledged that the zoning powers of the state had previously been used to regulate that industry. However, it is clear that many Congressmen thought the proposed legislation would allow the state to use the police power if its own constitution permitted. Congressman Edmondson stated in response to a question: "There is no question but what title I and title II specifically authorized stricter standards by a state if a state wishes to have them, both as billboard control and on the junkyard problem."[33] Many people interpreted the Federal Act to merely make compensation available if states either desired to pay compensation, or were forced by their own constitutions to do so.[34] They assumed that the use of the state police power to impose billboard control restrictions, which were the same or greater than those imposed by the federal statute, would continue to be available and would not impose an obligation to "justly compensate" upon either Federal or state Government.[35] For these people the opinion of the Attorney General declaring that a state risked losing its Federal-Aid Highway funds if it did not provide "just compensation" came as no small shock.[36]

When the beautification bill reached the floor of the Senate, initial opposition focused upon the 25 percent "just compensation" contribution of the states.[37] It was urged that the highway beautification program, being a national one, should be fully financed by the Federal Government.[38] Those in favor of total compensation by the Federal Government argued that the states were not in the position to accept such a heavy administrative and financial burden as the bill proposed to put upon them.[39] (There are 41,000 miles of interstate roads and 225,000 miles in the primary system,[40] and a federal report estimates the number of illegal signs outside commercial areas at 839,000.)[41] The fear was expressed by others that payment made solely by the Federal Government would relieve the

[32] *Id.* at 23798.

[33] *Id.* (remarks by Representative Edmunson).

[34] *See generally Hearings on S. 1467 Before the Subcomm. on Pub. Roads of the Senate Comm. on Pub. Works, Beautification and Highway Safety Programs,* 90th Cong., 1st Sess. 59-101 (1967).

[35] *Id.*

[36] Letters, *supra* note 12.

[37] 111 CONG. REC. 23796 (1965) (remarks by Senator Cooper).

[38] *Id.*

[39] *Id.* at 23871 (remarks by Senator Robertson).

[40] *Id.* at 23874 (remarks by Senators Holland and Randolph).

[41] The N.Y. Times, Aug. 31, 1969, at 42, col. 3.

states of all responsibility and would "lead toward inflated compensation payments."[42]

The proponents of state contribution were eventually successful in retaining the 25 percent compensation burden provision.[43] In explaining the interrelated functioning of sections 131(e,f) of the act, some members of the Senate strove to alleviate potential confusion on the part of the states legislatures when confronted by what appeared to be an intolerable financial drain upon state resources:

> Whatever interest remains at the particular time the States act to compensate them, they would be paid, but as the amortization period advanced, of course, then their property interests would be of less value.[44]

And more precisely:

> [A]ll that can be compensated for is whatever remains of the leaseholds or the unamortized values, so that if, in fact, the billboard has been completely amortized or the leasehold has expired, no compensation will be paid under the bill.[45]

These comments go a long way in explaining the 5-year period of nonconformance stipulated in section 131(e) and what role that period was intended to play in "just compensation." It was apparently thought that partial or even full amortization of both sign owner and property owner interests could be accomplished during that time, thus making "compensation" as described in the act partially or totally unnecessary.[46] Viewed in a slightly different perspective, a period of amortization could be seen as compensation; for that in essence is what the stipulated period of nonconformance accomplishes.

When one considers that amortization is a technique traditionally employed in phasing out a nonconforming use within the police power function of zoning,[47] and that compensation as referred to is classically spoken of in light of eminent domain,[48] the coupling of a nonconforming time period with "just compensation" appears incongruous and confusing — *but only when examined out of leg-*

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[42] 111 CONG. REC. 23874 (1965) (remarks by Senator Randolph).

[43] Highway Beautification Act, 23 U.S.C. § 131(g) (1965).

[44] 111 CONG. REC. 23872 (1965) (remarks by Senator Cooper).

[45] *Id.* (remarks by Senator Muskie). After looking through subcommittee testimony, Senator Neuberger had noted "that the signboard industry [felt] that it [could] amortize its investments in signboards in 5 years." *Id.* (remarks by Senator Neuberger).

[46] Highway Beautification Act, 23 U.S.C. § 131(g) (1965).

[47] *See generally* Katarincic, *Elimination of Nonconforming Uses, Buildings, and Structures by Amortization — Concept Versus Law,* 2 DUQUESNE L. REV. 1 (1963).

[48] DILLON, A TREATISE ON THE LAW OF MUNICIPAL CORPORATIONS 555 (5th ed. 1911).

islative context. Taking into account the existence of an extremely vocal billboard industry lobbying for compensation,[49] and the fact that in 1965, 36 states were able to regulate billboards by terminating without compensation, after allowing for amortization of costs,[50] it becomes clear that just compensation after a reasonable period of amortization was the logical Congressional solution to a perplexing legislative problem.

The correct and apparently Congressionally intended interpretation of section 131(g) is extremely important to the success of the Highway Beautification Act. If "just compensation" means "compensation" mitigated by "amortization" it could clearly result in a somewhat more manageable federal and state expenditure, while an interpretation requiring *full* compensation could not only preclude Congress from ever funding the project, but could also serve as an insurmountable impediment to other federal, state and local beautification-through-zoning projects.

The Administration bill which was considered by the Senate Committee on Public Works in May 1965, required that the Secretary of Commerce deny *all* highway funds to a state that did not comply with its provisions.[51] Strong opposition in the committee itself, to the imposition of this severe 100 percent penalty, succeeded in reducing it to a 10 percent forfeiture.[52]

The issue of whether the selection of a method of billboard control, previously left to the discretion of the states, can be taken from them by the 1965 act is worth examination. In his letter to the Secretary of Transportation, then Attorney General Ramsey Clark, responding to criticism that the act left the states no alternative to compliance, declared that an option did exist, — the states could ignore the act and incur the 10 percent penalty of its provisions.[53] Attorney General Clark cited *Massachusetts v. Mellon,*[54] wherein a suit was brought which attacked the constitutionality of legislation that provided matching funds to states for federally approved programs designed to improve maternal and child health care. By way of dicta, the Court said:

> Probably, it would be sufficient to point out that the powers of the state are not invaded, since the statute imposes no obligation,

[49] *See generally Hearings on S. 2084 Before the Subcomm. on Pub. Roads of the Senate Comm. on Pub. Works, Highway Beautification and Scenic Road Program,* 89th Cong., 1st Sess. 200-28, 278-353, 390-408 (1965).

[50] 111 CONG. REC. 26306 (1965) (remarks by Representative Pelly). This responsibility is currently the jurisdiction of the since established post of Secretary of Transportation.

[51] *Id.* at 23796 (remarks by Senator Cooper).

[52] Highway Beautification Act, 23 U.S.C. § 131(b) (1965).

[53] Letter, *supra* note 12.

[54] 262 U.S. 447 (1923), *overruled,* Flast v. Cohen, 392 U.S. 83 (1965).

> but simply extends an option which the state is free to accept or reject.[55]
>
> Nor does the statute require the states to do or to yield anything. If Congress enacted it with the ulterior purpose of tempting them to yield, that purpose may be effectively frustrated by the simple expedient of not yielding.[56]

The Attorney General believed that *Oklahoma v. United States Civil Service Commission*[57] was the case most nearly in point to the present situation. In *Oklahoma,* the state objected to the discharge by the Federal Government of a state employee, a member of its highway commission, for a violation of the Hatch Act,[58] a federal law. The state had received a grant of federal highway aid, and that grant was conditional on compliance with the Hatch Act. The Court upheld the position of the Civil Service Commission, declaring: "While the United States is not concerned with, and has no power to regulate, local political activities as such of state officials, it does have the power to fix the terms upon which its money allotments to states should be disbursed."[59]

The distinguishing element between the two cases cited by former Attorney General Clark and a case which could arise under the Highway Beautification Act of 1965 is obvious. In *Massachusetts,* matching funds for maternal and child health care were to be denied where federally-approved programs designed for that purpose were not utilized.[60] In *Oklahoma,* a state *highway* official could be dismissed by the Federal Government for violation of federal law, where the Federal Government participated in *highway* development in that state.[61] But under the 1965 Act, a state which refuses to participate in a national program of beautification not only forfeits Federal Government participation in the state's beautification effort, *i.e.* a 75 percent share of compensation payments, but must also sustain a 10 percent loss of federal funds for a defense-commerce project, the construction of highways. Analagous to the situation at hand would be a forfeiture of federal funds used in the construction of a state's medical facilities as a result of the state's unwillingness to comply with a federal program of recreation-area development. The two contentions appear equally preposterous.

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[55] 262 U.S. 447, 480 (1923).

[56] *Id.* at 482.

[57] 330 U.S. 127 (1947).

[58] Hatch Political Activities Act, 5 U.S.C. § 118 (*l*, k-n) (1964), 18 U.S.C. §§ 594-95, 600-01, 604-05, 608 (1964).

[59] Oklahoma v. United States Civil Service Comm'n, 330 U.S. 127, 143 (1947).

[60] Massachusetts v. Mellon, 262 U.S. 447 (1923), *overruled,* Flast v. Cohen, 392 U.S. 83 (1968).

[61] Oklahoma v. United States Civil Service Comm'n, 330 U.S. 127 (1947).

This inconsistency in the rationale of the penalty provision of the Highway Beautification Act of 1965 was noted in the Senate:

> [A]nd no state should be deprived of this assistance so necessary to provide a complete nationwide system for commerce and defense needs, by reason of not being able to qualify as a member in good standing of an extraneous program.[62]

Still another Senator commented:

> I do not know of any Federal-aid program, in existence or proposed, with the exception of this bill, which requires States to take legislative action and make appropriations under penalty of losing Federal-aid available under another program.[63]

The issue thus arises as to what provision "violations" will bring the 10 percent penalty into effect. The Attorney General's opinion[64] declared that the "just compensation" provision was a condition of avoiding the 10 percent reduction of section 131(b).

The major case to date interpreting the "just compensation" section,[65] *Markham Advertising Co. v. State,* held that its language was not mandatory and that Congress did not pre-empt the field but left the states free to act.[66] The court declared that Washington's billboard control statute which used police power was therefore valid. It stated:

> Our examination of § 131, supra, leads us to conclude that its essential operation is to condition payment of 10 percent of a State's share of federal-aid highway funds upon the state's exercise of its powers to regulate outdoor advertising in a manner consistent with federal standards. We think that the purpose of the federal statute is obviously to induce the States to act, not to require them to do so. The statute allows the state to choose between foregoing 10 percent of its allotment of federal-aid highway funds and compliance. If Congress had intended . . . [it] to be mandatory on the states, there would have been no need to attach a monetary penalty to noncompliance.[67]

The *Markham* case seems well reasoned and reflects the rule of long standing that conflicts between Federal and state Governments must be so "direct and positive" that the federal and state acts cannot "be reconciled or consistently stand together."[68] State legislatures, however, in other states still have to resolve the "compensation"

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[62] 111 CONG. REC. 26252 (1965) (remarks by Senator Berry).

[63] *Id.* at 23798 (remarks by Senator Cooper). Further substantiation of the fact that two different programs were therein involved may be found in the fact that § 131(g) of the act, suggesting "just compensation," was funded for fiscal years 1966 and 1967 not from the highway trust fund but from the general fund. *Id.* at 23869 (remarks by Senator Randolph).

[64] Letter, *supra* note 12.

[65] Highway Beautification Act, 23 U.S.C. § 131(g) (1965).

[66] 439 P.2d 248 (Wash. 1968), *appeal dismissed,* 393 U.S. 316 (1969). *See also* Southeastern Displays, Inc. v. Ward, 414 S.W.2d 573 (Ky. 1967).

[67] *Id.* at 257.

[68] *Id., quoting from* Kelly v. Washington, 302 U.S. 1, 9-10 (1937).

problem, knowing that their states may have the penalty imposed against them and that the courts may uphold the penalty in following the reasoning of the Attorney General's opinion.[69] For these legislatures the question is not so much the odds but the stakes. The traditional use of police power in this area will possibly deprive them of a significant portion of much needed highway funds.

Thus, although the 1965 Highway Beautification Act, when correctly interpreted to mean compensation after a period of amortization, permits compliance legislation which places a more reasonable financial burden upon the state, the act has attempted to give authority to the Federal Government to resolve problems previously within state jurisdiction which were well on the way to solution by state authorities. The zoning approach taken by the majority of concerned states which drafted billboard control legislation prior to the enactment of the 1965 act, contained no element of "just compensation."[70] An amortization period was considered to be compensation enough.[71] State and federal court decisions consistently upholding the constitutionality of zoning to control the spread of billboard blight along the highways,[72] furnish yet another reason why the states have not assumed a position of ready compliance to the 1965 act's "just compensation" provisions.

Congressional action, suggesting the use of eminent domain in the billboard control area, seems ironic upon consideration of the rapid emergence and acceptance of zoning as the police power tool by which aesthetics as an element of general welfare, or in its own right, can be protected by the states.[73]

A common device by which zoning regulations actually based upon aesthetics have been brought under the more traditional general welfare umbrella, has been to declare that the promotion of aesthetics

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[69] Letter, *supra* note 12.

[70] Records, *supra* note 16.

[71] *Id.*

[72] Euclid v. Amber Realty Co., 272 U.S. 365 (1926); St. Louis Poster Advertising Co. v. City of St. Louis, 249 U.S. 269 (1919); Thomas Cusack Co. v. City of Chicago, 242 U.S. 526 (1917); St. Louis Gunning Advertising Co. v. City of St. Louis, 235 Mo. 99, 137 S.W. 929 (1911), *appeal dismissed,* 231 U.S. 761 (1913); New York Thruway Authority v. Ashley Motor Court, Inc., 10 N.Y.2d 151, 176 N.E.2d 566, 218 N.Y.S.2d 640 (1961); Ghaster Properties, Inc. v. Preston, 176 Ohio St. 425, 200 N.E.2d 328 (1964).

[73] Eskind v. City of Nero Beach, 150 So. 2d 254 (Fla. 1962), *rev'd,* 159 So. 2d 209 (Fla. 1963); Sunad, Inc. v. City of Saratoga, 122 So. 2d 611 (Fla. 1960); Dade County v. Gould, 99 So. 2d 236 (Fla. 1957); Merritt v. Peters, 65 So. 2d 861 (Fla. 1953); City of Miami Beach v. Ocean & Inland Co., 147 Fla. 480, 3 So. 2d 364 (1941); State v. Diamond Motors, Inc., 50 Hawaii 33, 429 P.2d 825 (1967); City of New Orleans v. Pergament, 223 La. 14, 64 So. 2d 798 (1953); City of New Orleans v. Levy, 198 La. 852, 5 So. 2d 129 (1941); Town of Lexington v. Govenar, 295 Mass. 31, 3 N.E.2d 19 (1936); Cromwell v. Ferrier, 19 N.Y.2d 263, 225 N.E.2d 749, 279 N.Y.S.2d 22 (1967); People v. Stover, 12 N.Y.2d 462, 191 N.E.2d 272, 240 N.Y.S.2d 734 (1963); Ohio v. Buckley, 16 Ohio St. 2d 128, 243 N.E.2d 66 (1968); Oregon City v. Hartke, 240 Ore. 351, 400 P.2d 255 (1967).

will improve the economy and will thus benefit the general welfare.[74] In the Florida tourism cases,[75] zoning restrictions on billboards were upheld where the economic health of the city's major industry (tourism) was at stake, and therefore, the general welfare of the community's inhabitants was endangered. Somewhat similarly, in *City of New Orleans v. Pergament*[76] and *City of New Orleans v. Levy*,[77] the preservation of areas of historic interest was deemed to be sufficiently important to the city's economy, hence zoning towards that end was upheld as legislating for the general welfare.

In 1963, in *People v. Stover*,[78] the New York Court of Appeals wrote a landmark decision in the history of zoning. That case involved an ordinance prohibiting the maintenance of clotheslines in front or side yards abutted by a street. In the court's words:

> [I]t is our opinion that the ordinance may be sustained as an attempt to preserve the residential appearance of the city . . . .
>
> . . . .
>
> Once it be conceded that aesthetics is a valid subject of legislative concern, the conclusion seems inescapable that reasonable legislation designed to promote that end is a valid and permissible exercise of the police power.[79]

Making that concession, recognizing that the statute in question was based on aesthetic considerations, the court concluded that the ordinance was properly grounded on a proper exercise of the police power.[80]

As momentous as the *Stover* decision was to the field of zoning for aesthetics generally, equally momentous was the impact of *Cromwell v. Ferrier*,[81] another New York case decided in 1967 on the specific issue of billboard zoning for beautification. The ordinance in *Cromwell* set forth a comprehensive plan for regulating accessory signs, those related to a business located on the same lot, and implicitly prohibiting all others.[82] In discussing the validity of

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74 Eskind v. City of Nero Beach, 150 So. 2d 254 (Fla. 1962), *rev'd*, 159 So. 2d 209 (Fla. 1963); Sunad, Inc. v. City of Sarasota, 122 So. 2d 611 (Fla. 1960); Dade County v. Gould, 99 So. 2d 236 (Fla. 1957); Merritt v. Peters, 65 So. 2d 861 (Fla. 1953); City of Miami Beach v. Ocean & Inland Co., 147 Fla. 480, 3 So. 2d 364 (1941); City of New Orleans v. Pergament, 223 La. 14, 64 So. 2d 798 (1953); City of New Orleans v. Levy, 198 La. 852, 5 So. 2d 129 (1941).

75 The Florida Cases include: Eskind v. City of Nero Beach, 150 So. 2d 254 (Fla. 1962), *rev'd*, 159 So. 2d 209 (Fla. 1963); Sunad, Inc. v. City of Sarasota, 122 So. 2d 611 (Fla. 1960); Dade County v. Gould, 99 So. 2d 236 (Fla. 1957); Merritt v. Peters, 65 So. 2d 861 (Fla. 1953); City of Miami Beach v. Ocean & Inland Co., 147 Fla. 480, 3 So. 2d 364 (1941).

76 198 La. 852, 5 So. 2d 129 (1941).

77 223 La. 14, 64 So. 2d 798 (1953).

78 12 N.Y.2d 462, 191 N.E.2d 272, 240 N.Y.S.2d 734, *appeal dismissed*, 375 U.S. 42 (1963).

79 *Id.*, 191 N.E.2d at 274, 240 N.Y.S.2d at 738.

80 *Id.*, 191 N.E.2d at 276, 240 N.Y.S.2d at 738-39.

81 19 N.Y.2d 263, 225 N.E.2d 749, 279 N.Y.S.2d 22 (1967).

82 *Id.*, 225 N.E.2d at 751, 279 N.Y.S.2d at 24.

that ordinance, the court recognized that the primary objective of any anti-billboard ordinance is an aesthetic one, and rejected the notion that aesthetic objectives alone would not support a valid ordinance.[83] The court upheld the constitutionality of the ordinance in question and approved the enactment of legislation prescribing outdoor advertising, based primarily on aesthetic considerations. Billboard zoning for aesthetics was thus confirmed as a proper function of the police power.

Since the two New York decisions, other states have taken similar strides in the same direction. In *State v. Diamond Motors Inc.*,[84] the court declared:

> We accept beauty as a proper community objective, attainable through the use of police power. We are mindful of the reasoning of most courts that have upheld the validity of ordinances regulating outdoor advertising and of the need felt by them to find some basis in economics, health, safety, or even morality . . . . We do not feel so constrained.[85]

In *Ohio v. Buckley*,[86] statutes which required junkyards outside of a municipality to be obscured from the view of persons traveling on the city's roads, were held a valid exercise of the police power although they were based upon aesthetic considerations.[87] Earlier, the majority in *Oregon City v. Hartke*,[88] joined *Stover* in its holding that "aesthetic considerations alone [could] warrant an exercise of the police power."[89] With such precedents established, it is not surprising that today neither Ohio nor Oregon has fully implemented the 1965 Federal Beautification Act, and that both are regulating billboards by police power.[90]

As shown by the recent decisions in Hawaii,[91] New York,[92] Ohio,[93] and Oregon,[94] the *Stover* decision in 1963 rather than starting a trend in police power exercise — marked its culmination. State legislatures, municipal zoning groups, and the judiciary, had been promoting aesthetics through zoning for many years, cloaking

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83 *Id.*, 225 N.E.2d at 753, 279 N.Y.S.2d at 27.

84 50 Hawaii 33, 429 P.2d 825 (1967).

85 *Id.* at 827. The state supreme court was butressed in its decision by the HAWAIIAN CONST. art. 7, § 5: "The State shall have power to conserve and develop its natural beauty, objects and places of historic or cultural interest, sightliness and physical good order, and for that purpose private property shall be subject to reasonable regulation."

86 16 Ohio St. 2d 128, 243 N.E.2d 66 (1968), *appeal dismissed*, 395 U.S. 163 (1969).

87 *Id.*

88 240 Ore. 35, 400 P.2d 255 (1967).

89 *Id.*, 400 P.2d at 262.

90 Survey, *supra* note 2.

91 State v. Diamond Motors, Inc., 50 Hawaii 33, 429 P.2d 825 (1967).

92 Cromwell v. Ferrier, 19 N.Y.2d 263, 225 N.E.2d 749, 279 N.Y.S.2d 22 (1967); People v. Stover, 12 N.Y.2d 462, 191 N.E.2d 272, 240 N.Y.S.2d 734 (1963).

93 State v. Buckley, 243 N.E.2d 66 (Ohio 1968).

94 Oregon City v. Hartke, 240 Ore. 35, 400 P.2d 255 (1967).

their intent in an argument based primarily on health,[95] safety,[96] public welfare,[97] or morals.[98] While aesthetics had remained well hidden in the dicta of pre-*Stover* decisions, times had slowly changed and the attitudes of people toward aesthetics had changed with them.[99]

Whatever the reason for the ascendance of aesthetics, it appears certain that beauty has finally acquired the mantle of legislative and judicial respectability within the states. Were it not for the highway beautification program of 1965, state legislatures could clearly have a wide array of police power justification in preserving beauty along our Nation's highways.

For the foregoing reasons, the majority of state legislatures have not complied with the mandate of the Federal Highway Beautification Act of 1965. The fact that the Federal Government itself is not able to perform its obligations under the act — pay its share of compensation — has been a crucial factor in state noncompliance. Confusion has arisen over antithetical provisions which join "just compensation" and amortization concepts. Also, the act, in seeking to create a national program of beautification, has established a potentially dangerous precedent in threatening to withdraw a portion of federal funds from one federal-state program for a state's noncompliance with another.

In addition, in the interpretation of the act, there exists great confusion as to the effect of the term "compensation"; whether, despite the Attorney General's opinion,[100] the nonexistence of a direct and positive conflict between the Federal Act and an existing state act,[101] may still permit the state to operate under "stricter"[102] standards which utilize the police power?

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[95] *See generally* St. Louis Gunning Advertisement Co. v. St. Louis, 235 Mo. 99, 137 S.W. 929 (1911).

[96] *Id. See also* Los Angeles v. Barrett, 115 Cal. App. 2d 776, 315 P.2d 503 (1957); *In re* Opinion of the Justices, 103 N.H. 268, 169 A.2d 762 (1961); New York Thruway Authority v. Ashley Motor Court, Inc., 10 N.Y.2d 151, 176 N.E.2d 566, 218 N.Y.S.2d 640 (1961); Ghaster Properties, Inc. v. Preston, 176 Ohio St. 425, 200 N.E.2d 328 (1964).

[97] Eskind v. City of Vero Beach, 150 So. 2d 254 (Fla. 1962), *rev'd,* 159 So. 2d 209 (Fla. 1963), Sunad, Inc. v. City of Sarasota, 122 So. 2d 611 (Fla. 1960); Dade County v. Gould, 99 So. 2d 236 (Fla. 1957); Merritt v. Peters, 65 So. 2d 861 (Fla. 1953); City of Miami Beach v. Ocean & Inland Co., 147 Fla. 480, 3 So. 2d 364 (1941); City of New Orleans v. Pergament, 223 La. 14, 64 So. 2d 798 (1953); City of New Orleans v. Levy, 198 La. 852, 5 So. 2d 129 (1941); Town of Lexington v. Govenar, 295 Mass. 31, 3 N.E.2d 19 (1936).

[98] *See generally* St. Louis Gunning Advertisement Co. v. St. Louis, 235 Mo. 99, 137 S.W. 929 (1911).

[99] The Oregon supreme court described that change in attitude as "a reflection of the refinement of our tastes and the growing appreciation of cultural values in a maturing society." Oregon City v. Hartke, 240 Ore. 35, 400 P.2d 255 (1967).

[100] Letter, *supra* note 12.

[101] Markham Advertising Co. v. State, 439 P.2d 248 (Wash. 1968).

[102] Highway Beautification Act, 23 U.S.C. § 131(e) (1965).

Finally, courts have for many years recognized the constitutionality of controlling the billboard problem through zoning.[103] Suddenly, the application of eminent domain principles may be demanded of the states by an ambiguous federal act. The reaction of state government is understandably one of confusion.

Although the Highway Beautification Act of 1965 has generated much confusion, the act should not "join Prohibition in the Federal annals of noble experiment."[104] For the motivation of the Administration and the legislators who drafted and enacted it was one of an urgent interest in controlling our environment and preserving our Nation's heritage of natural beauty. A solution to this frustrating situation would be to amend the act to permit the states to elect their own techniques by which to enforce federal standards, thereby transforming the highway beautification program into an effective, truly federal effort. A return to the incentive system as presented in the 1958 Federal-Aid Highway Act,[105] but with an incentive offered to the states in the form of any needed highway beautification funds, could be an innovative aspect of that amended act.

Should amendment to the 1965 Act not be made by the current Congress, resort to the courts for clarification of ambiguities of the act will be necessary. A declaratory judgment action by a state official asking the court, under the Federal Administrative Procedure Act,[106] to determine whether there is a conflict between the Tenth Amendment[107] and the Attorney General's interpretation of section 131(g) of the 1965 Act would be brought. Such a course of action would probably involve extensive litigation, during which time noncomplying states, enforcing billboard controls by locally determined procedures, would be doing so under threat of penalty. It appears clear, then, that this confusing situation may be most expediently resolved by the Congress through its amendment procedures, and that it should be the Congress, therefore, that solves the problem which it has created.

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103 Euclid v. Amber Realty Co., 272 U.S. 365 (1926); St. Louis Poster Advertising Co. v. City of St. Louis, 249 U.S. 269 (1919); Thomas Cusack Co. v. City of Chicago, 242 U.S. 526 (1917); St. Louis Gunning Advertising Co. v. City of St. Louis, 235 Mo. 99, 137 S.W. 929 (1911), *appeal dismissed,* 231 U.S. 761 (1913); New York Thruway Authority v. Ashley Motor Court, Inc., 10 N.Y.2d 151, 176 N.E.2d 566, 218 N.Y.S.2d 640 (1961); Ghaster Properties, Inc. v. Preston, 176 Ohio St. 425, 200 N.E.2d 328 (1964).

104 The N.Y. Times, Aug. 31, 1969, at 42, col. 7.

105 Federal-Aid Highway Act, 23 U.S.C. § 122(c) (1958).

106 5 U.S.C. §§ 1001-11 (1964).

107 U.S. CONST. amend. X.

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The Law Journal is pleased to announce the election of the following editors for 1969-1970: Darryl G. Kaneko, *Editor-in-Chief;* Howard J. Beck, *Managing Editor;* Winthrop J. Davis, *Assistant Managing Editor;* Vance E. Halvorson, *Note Editor;* Bruce B. Johnson, *Business Editor;* Martin H. Shore, *Associate Editor;* S. Chandler Visher, *Associate Editor.*

NOTE

TIPPING VIOLATIONS AND CIVIL LIABILITY UNDER RULE 10B-5

INTRODUCTION

On August 13, 1968, the United States Court of Appeals for the Second Circuit handed down what has become, and what was expected to be,[1] one of the most significant decisions in the area of securities law rendered in the past decade.[2] *S.E.C. v. Texas Gulf Sulphur* dealt comprehensively with the expanded application of Rule 10b-5,[3] promulgated under Section 10(b) of the Securities and Exchange Act of 1934,[4] as a device to control insider trading.

Perhaps one of the most noteworthy aspects of *Texas Gulf Sulphur* was its holding that "tipping"[5] is a violation of Rule 10b-5.[6] It was clear at the outset from the cases interpreting Rule 10b-5 that

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[1] *See, e.g.*, Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 U. VA. L. REV. 1271 (1965); Kennedy & Wander, *Texas Gulf Sulphur, A Most Unusual Case*, 20 BUS. LAW. 1057 (1965); Mundheim, *The Texas Gulf Sulphur Complaint, A Major Step in Restricting Insider Trading in Corporate Securities*, 1966 J. BUS. L. 284.

[2] SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), *aff'g in part and rev'g in part*, 258 F. Supp. 262 (S.D.N.Y. 1966), *cert. denied*, 394 U.S. 976 (1969) (Justice White dissenting). For commentary on the District Court decision, *see, e.g.*, Ruder, *Corporate Disclosures Required by the Federal Securities Laws, The Codification Implications of Texas Gulf Sulphur*, 61 SW. U.L. REV. 872 (1967); Wiesen, *Disclosure of Inside Information — Materiality and Texas Gulf Sulphur*, 28 MD. L. REV. 189 (1968); Note, *SEC v. Texas Gulf Sulphur Co.: The Inside and Outside of Rule 10b-5*, 46 B.U.L. REV. 205 (1966); Note, *Texas Gulf Sulphur and the Duty of Disclosure, Another View*, 55 GEO. L.J. 664 (1967); Note, *Securities Transactions — SEC Rule 10b-5 — Disclosure of Material Information by Corporate Stock Optionees*, 41 TUL. L. REV. 722 (1967); Note, *Rule 10b-5 and Texas Gulf Sulphur: An Evolution of Questions and Answers*, 20 U. MIAMI L. REV. 939 (1966); Comment, 8 B.C. IND. & COM. L. REV. 353 (1967); Comment, 80 HARV. L. REV. 468 (1966); Comment, 65 MICH. L. REV. 944 (1967); Comment, 12 N.Y.L.F. 318 (1966). For commentary on the Circuit Court decision, *see, e.g.*, Bromberg, *Corporate Information: Texas Gulf Sulphur and its Implications*, 22 SW. L.J. 731 (1968); Note,*Scienter and Rule 10b-5*, 69 COLM. L. REV. 1057 (1969); Note, *Texas Gulf Sulphur Expanding Concepts of Corporate Disclosure Under SEC Rule 10b-5*, 43 ST. JOHN'S L. REV. 425 (1969); Note, *Securities — Rule 10b-5 is Violated Whenever an Insider Purchases Stock Without Disclosing Information that Would Affect the Judgment of a Reasonable Investor*, 47 TEXAS L. REV. 509 (1969); Note, *Texas Gulf Sulphur: Its Holdings and Implications*, 22 VAND. L. REV. 359 (1969); Comment, 35 BROOKLYN L. REV. 326 (1969); Comment, *Inside Trading on the Open Market: Nondisclosure and Texas Gulf Sulphur*, 42 S. CAL. L. REV. 309 (1969); Comment, *Securities Regulation — Trading by Insiders*, 10 WM. & MARY L. REV. 755 (1969).

[3] 17 C.F.R. § 240. 10b-5 (1969).

[4] 15 U.S.C. § 78a-hh-1 (1964).

[5] For definitions of "tipping," see text accompanying notes 29 & 34 *infra*.

[6] SEC v. Texas Gulf Sulphur, 401 F.2d 833, 852 (2d Cir. 1968).

a corporate or organizational insider, who purchases or sells securities issued by the corporation in a direct transaction with a member of the investing public without disclosing material inside information possessed by him, could be held in violation of 10b-5 and could be held civilly liable to the purchaser.[7] It also appeared that the "tippee"[8] of such an insider would be held to be in violation of the Rule and civilly liable, in the same manner as the corporate insider himself.[9] *Texas Gulf Sulphur* enlarged the scope of tipping regulation one step further in holding a *tipper who did not trade* in the securities in question to be in violation of the Rule.[10]

Texas Gulf Sulphur resolved some significant issues but also raised new ones to which it did not address itself. The most important of these is: Can *civil liability* be imposed on one who "tips" — *i.e.*, selectively discloses material inside information to one who thereafter trades in the security in question? If so, under what circumstances can the "tipper" be held liable, and to what extent?

The importance of this issue is clear. A tipper who is merely a violator of the Rule may be subject to an SEC action for injunctive or other administrative relief.[11] A tipper who is held civilly liable for his violation may be subject to a multiplicity of claims for damages suffered by those trading on the securities in question, as a result of the tipper's violation.[12]

Although a great number of factors may become involved in considering the primary question of "tipping" violations of Rule 10b-5, four underlying questions seem to be of crucial importance in discussing the imposition of civil liability for tipping violations:

(1) Who may be held to be subject to the Rule?

(2) What are the theoretical bases for holding "tipping" to

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[7] *See* text, section IV(C)(1) *infra.*

[8] A "tippee" is one who receives inside information by selective disclosure in breach of trust. However, the distinction between an "insider," as defined in the text accompanying note 25 *infra,* and a "tippee," as defined in the text accompanying notes 29 & 34 *infra,* is often blurred. As further discussion will point out, once a violation of Rule 10b-5 is found, it is felt that the distinction should not be crucial in determining the civil liability of such a person.

[9] *See* text, section IV(C)(2) *infra.*

[10] SEC v. Texas Gulf Sulphur, 401 F.2d 833, 852 (2d Cir. 1968).

[11] "It is not necessary in a suit for equitable or phophylactic relief to establish all the elements required in a suit for monetary damages." SEC v. Texas Gulf Sulphur, 401 F.2d 833, 863 (2d Cir. 1968), *quoting from,* Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 547 (2d Cir. 1967), *and* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963).

[12] *See* Ruder, *Texas Gulf Sulphur — The Second Round: Privity and State of Mind In 10b-5 Purchase and Sale Cases,* 63 NW. U.L. REV. 423, 441-44 (1968).

Approximately 59 private actions have been filed against Texas Gulf Sulphur Company, et al. Cannon v. Texas Gulf Sulphur Co., [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 97,372 n.2 (S.D.N.Y. Mar. 20, 1969). Only one of these is known to have been decided on the merits at this time. Reynolds v. Texas Gulf Sulphur Co., CCH FED. SEC. L. REP. ¶ 92,494 (Civil No. 132-66) (D. Utah Oct. 17, 1969).

be a violation of the Rule and the doctrinal grounds for imposition of civil liability therefor?

(3) In view of the fact that Rule 10b-5 requires that the prohibited acts be performed "in connection with the purchase or sale of any security,"[13] what types of transactions are subject to the Rule, and what constitutes a sufficient "connection with" the transaction?

(4) What additional factors must be considered in answering the above questions in connection with a civil action for damages, rather than an SEC action for injunctive or other administrative relief?

This Note will analyze the primary question generally, in terms of these four aspects of a Rule 10b-5 civil action. To clarify the considerations involved with each of the four aspects, they will be analyzed more or less independently of each other before attempting to determine the relationships between them and their combined effect upon the question of *liability*. For this reason and to provide the legal context in which the issues arise, the persons, the acts, and the transactions which fall within the ambit of 10b-5 for purposes of determining a *violation*, will first be considered.

I. PERSONS WHO MAY VIOLATE THE RULE

A. *Insider Violations under 10b-5*

Rule 10b-5 was promulgated in 1942 under section 10(b) of the Securities Exchange Act of 1934[14] and is one of many provisions in the securities laws designed to prevent fraud.[15] Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate [sic] commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which

[13] *See* text of Rule quoted in text accompanying note 16 *infra*.

[14] 15 U.S.C. § 78a-hh-1 (1964).

[15] SEC Securities Exchange Act Release No. 3230 (May 21, 1942) states:

> The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in the connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.

operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.[16]

The Rule does not utilize the word "insider." Nevertheless, the courts have interpreted Rule 10b-5 to mean "that a corporate insider purchasing stock from an outsider must disclose any material fact known to him by reason of his inside position but not known to the outsider."[17] In deciding who was to have the status of an insider, the courts have applied the rule to officers and directors,[18] and controlling shareholders.[19] The Commission has taken the position that any person trading unfairly in the stock of the corporation while knowingly possessed of information unavailable to the general public should be regarded as violating Rule 10b-5.[20] The SEC expanded the definition of insider by developing an "access test"[21] relying on the "any person" language in the Rule.[22] This expanded reading of the Rule was first presented in *Cady, Roberts & Co.*,[23] in which the Commission stated:

> We have already noted that the anti-fraud provisions are phrased in terms of "any person" and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and

[16] 17 C.F.R. § 240.10b-5 (1969).

[17] Ross v. Licht, 263 F. Supp. 395, 408 (S.D.N.Y. 1967).

[18] List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967); Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (N.D. Ill. 1952); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), *rehearing on other grounds*, 73 F. Supp. 798, *modified on other grounds*, 83 F. Supp. 613 (1947).

[19] Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951); Robinson v. Difford, 92 F. Supp. 145 (E.D. Pa. 1950).

[20] Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). *See also* Comment, *Liability for Failure to Disclose Under Rule 10-b-5*, 20 STAN. L. REV. 347, 352-53 (1968) [hereinafter cited as *Failure to Disclose*].

[21] Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). *See also* Bromberg, *Corporate Information: Texas Gulf Sulphur and Its Implications*, 22 SW. L.J. 731 (1968) [hereinafter cited as Bromberg, *TGS*].
Bromberg states:

> The SEC laid down an "access test" which treats as an insider anyone with a relationship to an issuer giving access, directly or indirectly, to information intended to be available only for a corporate purpose of the issuer. The test was adopted by both lower and upper courts in TGS, and was described by the latter as "the essence of Rule 10b-5."

Id. at 739.

[22] Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). *See also* Comment, *Insider Liability Under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine*, 30 U. CHI. L. REV. 121, 131 (1962); Daum & Phillips, *The Implications of Cady, Roberts*, 17 BUS. LAW. 939, 947-53 (1962).

[23] 40 S.E.C. 907 (1961).

> second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities.[24]

The "access test" thus defines or treats as an insider anyone who has a relationship to a corporation and either directly or indirectly is given access to information intended for corporate purposes.[25] The courts seem to be willing to accept this expanded definition.[26] In *SEC v. Texas Gulf Sulphur Co.*,[27] the Court of Appeals for the Second Circuit, speaking of the access test, stated:

> The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public.[28]

The door is thus opened for liability extending to many persons who receive inside information from the corporation.

B. *First Generation Tippees*

Tipping is generally "the selective disclosure of material inside (nonpublic) information for trading or other personal purposes."[29] The first case finding a 10b-5 violation by a tippee was *Cady, Roberts & Co.*,[30] which was also the first case applying the "access test."[31] Gintel, a partner in the broker-dealer firm, was given information by Cowdin, a director of Curtiss-Wright, prior to its public release. Upon receiving this information, Gintel called his associate at Cady, Roberts, and instructed him to buy Curtiss-Wright stock. In its opinion, the Commission stated: "Cowdin's relationship to the company clearly prohibited him from selling the securities affected by the information without disclosure. By logical sequence,

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[24] *Id.* at 912 (footnotes omitted).

[25] *Id.*

[26] *See* material quoted in note 21 *supra.*

[27] 401 F.2d 833 (2d Cir. 1968).

[28] *Id.* at 848 (footnote omitted).

[29] A. BROMBERG, SECURITIES LAWS: FRAUD — SEC RULE 10b-5 § 7.5(2) (1969) [hereinafter cited as BROMBERG, FRAUD]. For a discussion of the obligation of tippees to disclose, see 3 L. LOSS, SECURITIES REGULATION 1451 (2d ed. 1961) [hereinafter cited as LOSS].

[30] 40 S.E.C. 907 (1961).

[31] *See* note 24 *supra* and accompanying text. It is possible that Cady, Roberts & Co. is more properly classified as an insider under the "access test." *See* note 10 *supra* and text accompanying note 25 *supra.* However, *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967), cited *Cady, Roberts & Co.* for the proposition that *tippees* are subject to the same duty as insiders. *Id.* at 410.

it should prohibit Gintel, a partner of registrant. This prohibition extends not only over his own account, but to selling for discretionary accounts and soliciting and executing other orders."[32] More force was added to the prohibition against trading by tippees in *Ross v. Licht.*[33] The court in that case defined tippees as "persons given information by insiders in breach of trust...."[34] Although this was a civil action brought under Rule 10b-5, a finding of violation by the "tippees" is implicit[35] in the court's holding that the "tippees" were civilly liable.[36] Also, the court's opinion in *Texas Gulf Sulphur* stated that an insider will be found in violation for "tipping," and intimates that tippees would be found to be in violation, as well, because their conduct could be as reprehensible as the insider's.[37]

C. *Subsequent Generation Tippees*

An expansion of the tippee concept is that of the tippee's tippee. If an insider has told another, thus making the other a tippee, then that tippee may in turn disclose this information to still another, making him a second generation tippee. Information travels rapidly and may reach many ears after it has been initially divulged. Thus, in a matter of hours the number of subsequent generation tippees could be large. A 10b-5 violation has not yet been found on the part of subsequent generation tippees, but the possibility is not remote.

The question which must be resolved relates to how far the disclosures can go in the ladder of tippees and still be a violation of 10b-5. Bromberg suggests that "not all tippees are in the same position."[38] He proposes the following criteria for determining a tippee's violation: "A tippee violates if he (1) trades with specific material information which he knows (or should reasonably know) comes from an inside source and (2) knows (or should reasonably know) that the information is undisclosed to the public."[39] Such a test might be an answer to the problem of avoiding a finding of violation on the part of remote tippees who may not be cognizant of the quality of their information.

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[32] Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (footnote omitted).

[33] 263 F. Supp. 395 (S.D.N.Y. 1967).

[34] *Id.* at 410.

[35] In order to find someone civilly liable under 10b-5, there must, of course, be a violation of the Rule.

[36] Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967). This holding is somewhat weakened by the fact that the court also held the "tippees" liable on the alternative ground of aiding and abetting a violation of 10b-5.

[37] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 853 (2d Cir. 1968).

[38] Bromberg, *TGS, supra* note 21, at 747.

[39] *Id.* at 749.

II. TIPPING AS A VIOLATION OF THE RULE

The above discussion has focused primarily on the question of finding a violation of Rule 10b-5 on the part of certain classes of persons, particularly tippees, when such persons *trade* in the stock in question. However, the question here under consideration involves a tipper who does *not* trade in the stock. Civil liability, if any, must be based upon the act of tipping — selective disclosure to a "tippee" who trades in the stock. The status of tipping as a violation of 10b-5 will be briefly considered here.

Perhaps the classic and most common tipping situation is that suggested by the *Cady, Roberts case.*[40] In that case a partner of Cady, Roberts & Co., a broker-dealer firm, received material inside information from an insider of the issuer of the securities in question. The partner thus became a tippee or "first generation tippee" of the insider. Although the *Cady, Roberts* decision held that such a tippee was prohibited from trading the securities affected by the information not only for his own account, but for discretionary accounts as well,[41] the "first generation tippee" (broker-dealer) could just as well have passed the inside information on to the discretionary accounts or other preferred customers ("second generation tippees"), thus allowing *them* to trade the securities based upon the inside information.

The problem is one of deciding what action was permitted the broker-dealer on receipt of the corporate information. Superior knowledge in the field of securities and a greater understanding in the interpretation of information received are the skills of a broker. Yet, does the broker have the duty to disclose all information he receives to his customers? In *Cady, Roberts,* Commissioner Cary answered the question negatively by stating:

> While Gintel [the broker] undoubtedly occupied a fiduciary relationship to his customers, this relationship could not justify any actions by him contrary to law. Even if we assume the existence of conflicting fiduciary obligations, there can be no doubt which is primary here. On these facts, clients may not expect of a broker the benefits of his inside information *at the expense of the public generally.*[42]

Although the *Cady, Roberts* case itself involved a trading violation by a tippee, the recent *Texas Gulf Sulphur* case squarely held tipping to be a violation of Rule 10b-5.[43]

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[40] 40 S.E.C. 907 (1961).

[41] *Id.* at 912.

[42] Cady, Roberts & Co., 40 S.E.C. 907, 916 (1961) (emphasis added) (footnote omitted). *See also* Comment, *Insider Liability Under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine,* 30 U. CHI. L. REV. 121, 155 (1962).

[43] SEC v. Texas Gulf Sulphur, 401 F.2d 833, 852 (2d Cir. 1968). *See also* SEC v. Glen Alden Corp., SEC Litigation Release No. 4080, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,280 (S.D.N.Y. August 7, 1968).

It is interesting to note that the disclosure problem of broker-dealers is not confined to the infrequent receipt of "tips" from corporate insiders. Broker-dealers frequently undertake to underwrite a securities issue of a corporation, thus becoming an insider of the issuer having special access to inside information. In this situation, if the broker does not have a primary duty to disclose to his clients the information he receives, what procedure should be employed when he receives such information?[44] Three alternatives seem to exist. He could disclose to the public the information he possesses; he could refrain from trading in the stock and from disclosing the information to others until the corporation disseminates this information; or underwriting departments could be kept entirely separate from sales departments.

Complications arise in using either of the first two alternatives. First, most brokerage firms do not possess the facilities to disseminate this information quickly to the public.[45] Also, dissemination by the broker (who is also an underwriter) may violate his duty to the corporation.[46] It has been suggested that if a broker were to reveal the information to all of his clients to their satisfaction, this would relieve him from liability.[47] However, it has been held that when specific antifraud sections are violated, it is not a defense that all the broker's clients are content.[48] This is justified on the grounds that the broker's duty is to the general public and is not limited to his clients.[49]

There are also problems in using the second alternative — prohibiting the broker from making a market in securities about which he possesses inside information. If a client should request to sell the specific stock, and the broker must reply that he is unable to trade that stock this week, the broker's function may be substantially impaired. One author suggests that the refusal to trade may deter legitimate investments.[50] Loss, on the other hand, states that "a broker or dealer who becomes a corporate insider must

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[44] *See* Note, *Civil Liability Under Section 10B And Rule 10b-5: A Suggestion For Replacing The Doctrine Of Privity,* 74 YALE L.J. 658, 675 (1965). *See also* Cary, *Corporate Standards and Legal Rules,* 50 CAL. L. REV. 408, 415 (1962). The broker should not be permitted to remain silent, while continuing to deal in the security, "by reason of the inherent unfairness involved where a person takes advantage of information knowing it is unavailable to those with whom he is dealing." *Id.*

[45] *See* Comment, 75 HARV. L. REV. 1449, 1451 (1962).

[46] 3 Loss, *supra* note 29, at 1453.

[47] Hughes v. SEC, 174 F.2d 969, 974 (D.C. Cir. 1949).

[48] *Id.*

[49] Cady, Roberts & Co., 40 S.E.C. 907, 916 (1961); Comment, *Insider Liability Under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine,* 30 U. CHI. L. REV. 121, 155-58 (1962).

[50] *Failure to Disclose, supra* note 20, at 356.

assume the risk that his duty to the corporation may sometimes prevent him from making a market in its securities."[51]

The third alternative appears to be the most satisfactory. By keeping the underwriting and sales departments entirely separate, the problem of conflicting interests may be alleviated by preventing the information from reaching the point at which it could be used in trading in violation of the Rule.[52]

It is worthy of note that this problem is not unique to underwriting and sales departments of brokerage firms. Similar problems exist as to attorneys, C.P.A.'s, banks,[53] and financial specialists. They are in constant contact with corporations and have access to inside information. Speaking to the question of who may be an insider, the court in *SEC v. Texas Gulf Sulphur Co.*[54] stated: "Thus, *anyone* in possession of material inside information must either disclose it to the investing public, or, *if he is disabled from disclosing it in order to protect a corporate confidence,* or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."[55] Under the court's ruling, if an attorney, accountant, or bank were to relay his corporate information to another or trade in the stock, he would be in violation of Rule 10b-5. In normal circumstances, a means to avoid liability would be to disclose to the public the information. However, in the case of this select group, such disclosure would frequently constitute a breach of their fiduciary duty to the corporation. Thus the only course of action open to these individuals, once they receive the corporate confidence, is to refrain from trading in or recommending the stock while the information is undisclosed.

Financial specialists, however, present a somewhat different problem. They are theoretically not allowed access to the corporate confidences, yet, due to their expertise in the evaluation of information, a fact not material to the general public may have high significance to the specialist. The SEC, in *Cady, Roberts,* stated that "perceptive analysis of generally known facts" would not constitute a violation of the Rule.[56]

Sections I and II above have presented part of the legal context in which the questions raised at the beginning of this Note must

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[51] 3 LOSS, *supra* note 29, at 1453 (footnote omitted).

[52] The Commission has taken this position in its *Statement of Policy* appended as Exhibit A to its ruling *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Securities Exchange Act Release No. 8459, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629, at 83,351 (SEC November 25, 1968).

[53] *See generally,* Harfield, *Texas Gulf Sulphur and Bank Internal Procedures Between the Trust and Commercial Departments,* 86 BANKING L.J. 869 (1969).

[54] 401 F.2d 833 (2d Cir. 1968).

[55] *Id.* at 848 (emphasis added).

[56] Cady, Roberts & Co., 40 S.E.C. 907, 915 (1961).

be considered. It appears that Rule 10b-5 has been extended to first generation tippees who trade in the securities in question. Coverage may be extended to subsequent generation tippees who trade in the securities. The focus of this Note, however, is directed to the question of whether such a person can be held civilly liable for tipping — selective disclosure to a subsequent generation tippee who trades in the stock. Although tipping has been found to be within the prohibition of Rule 10b-5, the resolution of the question of civil liability for such acts depends upon certain legal considerations to be discussed in subsequent sections of this Note.

III. Transactions Subject to the Rule

Securities transactions have traditionally fallen into two categories:

(1) *direct* face-to-face transactions in which the parties have an opportunity to disclose to one another anything that may be required;

(2) *indirect* or market transactions in which the parties have no direct dealings and may make representations and disclosures only indirectly through the public media.

Rule 10b-5 case law developed initially in direct transactions, but courts gradually have begun to find 10b-5 violations in indirect transaction cases.[57] This section will address itself to a brief survey of the cases finding violations in both types of transactions. It will not be the purpose of this section to analyze all of the developments concerning transaction violations, but to establish a point of reference for a discussion of civil liability in various transaction situations discussed in section IV of this Note.

A. *Direct Transactions*

Direct transactions may be of varied types. For example, when a seller holding stock in a closed corporation sells directly to a purchaser, without using a broker, nondisclosure of a material fact in connection with such a transaction, while disclosing other facts, is a violation of the second clause of Rule 10b-5.[58] Another example of a direct transaction violation is a broker failing to disclose a material fact during negotiations with his customer.[59] A survey of the myriad

[57] *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); Cady, Roberts & Co., 40 S.E.C. 907 (1961).

[58] Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) *rehearing on other grounds*, 73 F. Supp. 798, *modified on other grounds*, 83 F. Supp. 613 (1947) (where failure to disclose the possibility of a sale of corporate assets during negotiations was held a violation).

[59] Van Alstyne, Noel & Co., 33 S.E.C. 311 (1952) (holding a broker in violation for failure to disclose to its investors the deteriorating financial condition of the issuer of securities).

of direct transactions is beyond the scope of this Note, and the area has been thoroughly explored by Professor Bromberg.[60] Suffice it to say that direct transactions are clearly within the scope of Rule 10b-5.[61] Furthermore, in private 10b-5 actions based on direct transactions of all types, the courts will entertain the suit, acknowledging that privity and the other requirements based upon the relationship of the parties to the transaction are present.[62]

B. *Indirect Transactions*

The typical indirect transaction is the open market purchase, where the seller has no face-to-face contact with the purchaser. While early cases involved direct transactions, the *Cady, Roberts* and *Texas Gulf Sulphur* decisions set precedents for market transaction violations.[63] The SEC in *Cady, Roberts* stated that "[n]either the statutes nor Rule 10b-5 establish artificial walls of responsibility,"[64] in applying the Rule to a market transaction violation. In *Texas Gulf Sulphur* the Second Circuit cited the *Cady, Roberts* decision with approval in holding the corporate defendant in possible violation of the Rule for trading in an indirect transaction.[65]

In another administrative action,[66] the Commission has taken the position that a 10b-5 violation can be found where the registrant, a broker-dealer, did not trade in the market itself, but effected transactions in the market for its preferred customers based on inside information.[67]

The discussion of civil liability in the next section of this Note will assume, for purposes of analysis, a violation of 10b-5.[68]

IV. CIVIL LIABILITY UNDER THE RULE

Prior discussion has focused upon the questions of whether or not a "tipper" can be found to be in violation of Rule 10b-5 for selectively disclosing material inside information to subsequent generation tippees who thereafter trade in the securities, and whether

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[60] BROMBERG, FRAUD, *supra* note 29, §§ 4.1-6.6.

[61] *Id.*

[62] *Id.*

[63] Early cases brought for broker violations of 10b-5 raised the issue of indirect transaction violation but did not resolve the issue due to decisions on other grounds. Fry v. Schumaker, 83 F. Supp. 476 (E.D. Pa. 1947); Hughes & Treat, 22 S.E.C. 623 (1946).

[64] 40 S.E.C. 907, 913 (1961).

[65] 401 F.2d 833, 848 (2d Cir. 1968).

[66] Merrill Lynch, Pierce, Fenner & Smith, Inc., Securities Exchange Act Release No. 8459, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629 (SEC November 25, 1968).

[67] *Id.* at 83,349.

[68] The reader who seeks a detailed discussion of indirect transaction violations will find such a discussion in BROMBERG, FRAUD, *supra* note 29, §§ 7.1-7.6.

or not such a violation can be found where the tippee trades in an indirect transaction. Assuming that a violation can be found in such a situation, the remaining discussion will center on the question of whether or not civil liability can arise from these situations, and, if so, what is or ought to be the extent of liability? The analysis here will be in terms of the distinctions drawn in the first three sections of this Note.

A. *The Development of a Theory of Liability*

Rule 10b-5 does not specifically provide for a private cause of action for a violation of its provisions. Sections 12(2)[69] and 17(a)[70] of the Securities Act of 1933, and section 16(b)[71] of the Securities Exchange Act of 1934 also relate to the regulation of insider securities transactions, but have not been utilized to protect the outsider to the same extent as Rule 10b-5.[72]

Civil liability under 10b-5 began, and is presently based on an implied right of recovery.[73] *Kardon v. National Gypsum Co.*[74] was an early case establishing insider civil liability based on a tort theory that violation of a statute (section 10b) makes the actor liable in a private action for injury to another.[75] Some decisions have attached

[69] Securities Act of 1933, 15 U.S.C. § 77*l* (1964). The relevant portion of section 12 states:

> Any person who —
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> . . . .
>
> (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof) [by the use of interstate commerce] . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in exercise of reasonable care could not have known, of such untruth or omission, shall be liable *to the person purchasing* such security from him . . . . (Emphasis added).

This section, in imposing civil liability for violations similar to 10b-5 violations, seems to be the logical statutory provision under which an action for misrepresentation would be brought by a purchaser under the securities laws. Nevertheless, 10b-5 has found more favor as a remedial cause of action. It may be surmised that this is so because of the *scienter* criteria stated in section 12(2), because of the early expansion of Rule 10b-5 liability by the courts, and because 10b-5 provides a remedy for the seller as well as for the purchaser. *See* text accompanying notes 80 & 81 *infra.*

[70] Securities Act of 1933, 15 U.S.C. § 77q (1964). This section reads very nearly the same are Rule 10b-5.

[71] Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1964).

[72] Note that section 16(b) is rather restrictive in limiting liability to corporate officers, directors and principal stockholders who sell within 6 months of date of purchase. Thus, its utility as a pervasive antifraud provision is similarly restricted.

[73] For a discussion of the development of an implied right of recovery see BROMBERG, FRAUD, *supra* note 29, § 2.4(1).

[74] 69 F. Supp. 512 (E.D. Pa. (1946), *rehearing on other grounds,* 73 F. Supp. 798. *modified on other grounds,* 83 F. Supp. 613 (1947).

[75] *Id.* at 513.

liability based on the theory that section 29(b) of the Exchange Act[76] makes a contract consummated in contravention of section 10(b) voidable at the option of the innocent party.[77] The existence of a private cause of action under Rule 10b-5 is now well established.[78]

Less established has been the right of a *buyer* to sue under the Rule. Early decisions[79] did not recognize the right of recovery by a defrauded buyer, though the *Kardon* case[80] had previously permitted recovery by a defrauded seller. More recent decisions have permitted a buyer to bring suit under Rule 10b-5.[81] Thus, case law has developed the notion that private causes of action by defrauded buyers or sellers may be brought under Rule 10b-5.

B. *Doctrines Limiting Liability*

Where 10b-5 cases have been prosecuted by the SEC, the only showing necessary for injunctive or other relief has been a violation of the Rule.[82] However, when private litigants initially brought suits under 10b-5, the notion of privity came to the forefront, along with materiality, reliance, and causation as the elements of common law deceit. In private actions, the courts felt that there must be some relationship between the defendant's violation of the Rule and the plaintiff's injury to permit recovery.[83] This requirement was described in 1951 as "[a] semblance of privity between the vendor and purchaser of the security . . . ."[84] Since 1951 the trend has been away from requiring any direct dealings between plaintiff and

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[76] 15 U.S.C. § 78cc(b) (1964).

[77] Bromberg discusses the development of the notion of statutory voidability in BROMBERG, FRAUD, *supra* note 29, § 2.4(1)(b).

[78] Ten of the eleven courts of appeal have recognized a private cause of action. *See* J.I. Case Co. v. Borak, 377 U.S. 426 (1964); 6 LOSS, *supra* note 29, at 3871-73; Annot., 37 A.L.R.2d 649 (1954), and authorities cited therein.

[79] Montague v. Electronic Corp. of America, 76 F. Supp. 833 (S.D.N.Y. 1948); Rosenberg v. Globe Aircraft Corp., 80 F. Supp. 123 (E.D. Pa. 1948).

[80] Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), *rehearing on other grounds,* 73 F. Supp. 798, *modified on other grounds,* 83 F. Supp. 613 (1947).

[81] Doelle v. Ireco Chemicals, 391 F.2d 6, 9 (10th Cir. 1968); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964). The *Ellis* case specifically considered the development of the notion of a buyer's right to recovery concluding that such right was concomitant with that of a seller. Ellis v. Carter, *supra* at 272-74.

[82] Cady, Roberts & Co., 40 S.E.C. 907, 914-15 (1961). *See also* Merrill Lynch, Pierce, Fenner & Smith, Inc., [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629 at 83,345 n.5 (SEC November 25, 1968).

[83] *See* text accompanying note 112 *infra.*

[84] Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd,* 198 F.2d 883 (2d Cir. 1952). *See also* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952). For an interesting discussion of what is meant by the term "semblance of privity," see H. BLOOMENTHAL, SECURITIES LAW 600 (1966).

defendant.[85] Decisions in the Second and Sixth Circuits have minimized the importance of privity between plaintiff and defendant in private actions.[86] The current approach seems to be that absence of privity "does not amount to a fatal defect of proof."[87]

A requirement that a defendant only be sued by those to whom he sold or from whom he bought has the advantage of limiting potential damages. If the class of potential plaintiffs is expanded to include all persons who bought or sold in the market, the possibility of recoveries against one defendant for an amount greater than the damages caused by his own transactions greatly increases.[88] This would be possible because once a causal link is established to one plaintiff in the market, a similar link could be found with many other potential plaintiffs in the same position. One way to avoid this pitfall would be to limit the plaintiffs' recovery to the amount of the defendant's profit. But such an approach would cause other problems such as a rush to get an early execution of judgment before the defendant's liability limit was reached.

On the opposite side of this question there is the argument that equating plaintiffs' recovery to defendant's profit would mean that plaintiffs could have no cause of action where the defendant did not make a profit. This would seem to be contrary to the intent of the Rule and to holdings that a person may be in violation of 10b-5 even when he loses money in the transaction.[89] Elimination of a significant avenue of recourse in 10b-5 private actions in this manner would decrease their deterrent effect.[90]

If materiality of the information is assumed and privity is found present, factors such as causation and reliance are assumed to be present.[91] When privity limitations on the relationship between

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[85] Note, *Civil Liability Under Section 10(b) and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity,* 74 YALE L.J. 658, 663 n.31 (1965).

[86] Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962); Brown v. Bullock, 194 F. Supp. 207, 229-30 (S.D.N.Y.), *aff'd,* 294 F.2d 415 (2d Cir. 1961). *But see* Kuenhert v. Tekstar Corp., 412 F.2d 700, 702 (5th Cir. 1969).

[87] Cochran v. Channing Corp., 211 F. Supp. 239, 245 (S.D.N.Y. 1962). *See also* 3 LOSS, *supra* note 29, at 1767-71; 6 LOSS, *supra* note 29, at 3896; BROMBERG, FRAUD, *supra* note 29, § 8.5 n.28.

[88] *See* Ruder, *Texas Gulf Sulphur — The Second Round: Privity and State of Mind In Rule 10b-5 Purchase and Sale Cases,* 63 NW. U.L. REV. 423, 441-44 (1968).

[89] "[W]e are not convinced of any difference in substance between a successful fraud and an attempt. The statutory phrase 'any manipulative or deceptive device,' 15 U.S.C. § 78j(b), seems broad enough to encompass conduct irrespective of its outcome." Kuenhert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969).

[90] J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964). The *Borak* case, a section 14 Exchange Act case, lends judicial sanction to the notion that private actions have a strong position in the scheme of federal securities laws and that appropriate civil remedies should be provided to effect the purpose of these laws.

[91] Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion For Replacing The Doctrine of Privity,* 74 YALE L.J. 658, 684-85 (1965); Ruder, *Texas Gulf Sulphur — The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases,* 63 NW. U.L. REV. 423, 433-34 (1968).

the parties were removed, these other factors were looked to independently in order to establish (or limit) liability.[92] It is the development of causation and reliance and to a lesser extent forseeability as tests of liability, and specifically their application to insider and tippee violations involving market transactions, that will be discussed in the following subsections.

C. *Civil Liability in Direct Transactions*

It is now seen that in order to sustain a private civil action under Rule 10b-5, a plaintiff must not only show a violation of 10b-5, but must also show some sort of relationship between his loss and the defendant's violation — whether this relationship be couched in terms of a concept of privity or a formulation for causation and reliance or foreseeability.[93] The remainder of this analysis will consider this theory of civil liability in terms of the distinctions delineated in sections I, II, and III of this Note.

1. Corporate Insiders

A face-to-face transaction between an insider acting in violation of Rule 10b-5 and an innocent purchaser has generally been held to result in insider civil liability. For example, when the purchaser of securities in a direct transaction is the deceiving party (though incomplete disclosure or nondisclosure), and the seller, in reliance[94] on the presumed full disclosure of the purchaser, suffers damage, liability of the purchaser ensues.[95] The courts, whether through a theory of tort liability[96] or statutory voidability of the transaction,[97] have permitted recovery in these direct transactions.[98]

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[92] Ruder, *Texas Gulf Sulphur — The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423, 434 n.61 (1968); *see* text accompanying note 112 *infra*.

[93] The element of "scienter," which is also arguably necessary to sustain liability in 10b-5 cases, will not be considered in this analysis. For a general discussion of "scienter" in 10b-5 civil actions, see *Weber v. C.M.P. Corp.*, 242 F. Supp. 321 (S.D.N.Y. 1965) and authorities cited therein.

[94] "Reliance is an essential element of a cause of action under Rule 10b-5." Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

[95] *Id.* at 411; Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), *rehearing on other grounds*, 73 F. Supp. 798, *modified on other grounds*, 83 F. Supp. 613 (1947).

[96] Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), *rehearing on other grounds*, 73 F. Supp. 798, *modified on other grounds*, 83 F. Supp. 613 (1947).

[97] Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), *rehearing on other grounds*, 73 F. Supp. 798, *modified on other grounds*, 83 F. Supp. 613 (1947). The *Kardon* case also discussed the alternative holding that the contract involved in the transaction would be voidable under section 29 of the Exchange Act.

[98] A recent decision has permitted recovery also where the corporate insider failed to disclose material information to *existing* shareholders of the corporation. Reynolds v. Texas Gulf Sulphur Co., CCH FED. SEC. L. REP. ¶ 92,494, (Civil No. 132-66) D. Utah Oct. 17, 1969).

2. First Generation Tippees

While the language of Rule 10b-5 refers to "any person" who "directly or indirectly" engages in certain acts,[99] early cases required privity — similar to privity in contract law — in the transaction between plaintiff and defendant to sustain a private cause of action.[100] Though the requirement of privity has been generally obviated,[101] the notion retains some validity here in a discussion of tippee liability in a direct transaction. In a face-to-face transaction where a first generation tippee sells directly to or purchases directly from a party, privity of contract is present. Certainly a tippee in such a situation, being under the same duty as an insider,[102] and meeting the criteria of the Rule as "any person," should be a logical person to hold liable in a private 10b-5 action. Notions of statutory tort liability and statutory voidability are applicable to such a tippee who is the violator of the Rule.[103] *Ross v. Licht* was a private action where tippee liability was mentioned but was not the sole ground for imposing liability. The court noted that "[i]f Sidney Grapel and Bluestone were not insiders, they would seem to have been 'tippees' (persons given information by insiders in breach of trust) and subject to the same duty as insiders."[104]

More recently, the Fifth Circuit, in a private action involving a tippee who had violated Rule 10b-5 has noted that "tippees . . . present the same threat to the investigating public as do insiders . . . ."[105] Although this case involved the denial of recovery to a tippee seeking redress from a tipper for giving a false tip, the court said in dictum that if the information had been true, the *tippee* would, "of course, be liable to his vendors or vendees . . . ."[106]

While the courts have not considered tippee liability in direct transactions to any great degree, the reasoning of the *Ross* case is persuasive in extending liability in a private action to such persons.[107]

3. Subsequent Generation Tippees

A tippee's tippee who violates Rule 10b-5 should stand in much the same position, insofar as civil liability is concerned, as

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99 *See* text accompanying notes 16 and 22 *supra*.

100 *See, e.g.*, Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd* 198 F.2d 883 (2d Cir. 1952) (requiring some "semblance of privity").

101 Cochran v. Channing Corp., 211 F. Supp. 239, 243-45 (S.D.N.Y. 1962); Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14, 24 (W.D. Ky. 1960). *But see* Kuenhert v. Texstar Corp., 412 F.2d 700, 702 (5th Cir. 1969).

102 Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967). *See* 3 Loss, *supra* note 29, at 1451.

103 *See* BROMBERG, FRAUD, *supra* note 29, § 2.4(1)(a-b).

104 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

105 Kuenhert v. Texstar Corp., 412 F.2d 700, 705 (5th Cir. 1969).

106 *Id.*

107 *See* Bromberg, *TGS*, *supra* note 21, at 749.

the tippee himself. No case law has been found, however, sustaining such liability.[108] Nevertheless, the purpose of protecting the investing public from unfair inequalities in bargaining power would be furthered if liability were imposed on a subsequent generation tippee in a direct transaction.[109] Similarly, the fact that privity exists in a direct transaction sustains this theory of liability. Unlike the indirect transaction,[110] the extension of liability to persons who materially misrepresent in a face-to-face transaction does not raise the question of holding persons liable whose acts in fact have no causal relation to the losses of the innocent party. In this context it should not ordinarily matter how a defendant received his inside information, but only that in a transaction with the plaintiff he failed to disclose such information. Certainly the defendant falls within the meaning of the Rule's criterion of "any person."

4. Persons Subject to Civil Liability in Direct Transactions

In summary, it appears that persons who violate Rule 10b-5 through direct transactions may also be subject to civil liability for the violation. The requirement of privity can easily be met by the plaintiff who has traded directly with the person who has violated Rule 10b-5. However, as indicated in section I of this Note, subsequent generation tippees have not yet been held to be in violation of the Rule.

D. *Civil Liability in Indirect Transactions*

As mentioned in section III(B) *supra*, the courts have recently extended the scope of application of Rule 10b-5 to include indirect transactions for purposes of determining a violation of the Rule.

For purposes of finding civil liability under 10b-5, however, the fact that the transaction involved is indirect is significant. It will have a decisive effect in determining the existence of privity — or causation and reliance — which is necessary in a civil action under the Rule. Certainly privity is not present between a plaintiff and a defendant who have traded the same security in an impersonal market. However, the requirement of privity has not been emphasized in recent decisions. The courts have, rather, looked to the elements of reliance or causation in order to find a connection between a defendant's violation of 10b-5 and a plaintiff's losses. The status of

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[108] However, the *Cady, Roberts* opinion suggests such liability when it states: "Section 17 and Rule 10b-5 apply to securities transactions by any person. Misrepresentations will lie within their ambit, *no matter who the speaker may be*." Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961) (emphasis added).

[109] The *Cady, Roberts* opinion indicates that the purpose of the antifraud provisions is to prevent the taking of undue advantage of investors and others. *Id.*

[110] *See* section IV(D) *infra.*

concepts limiting civil liability under Rule 10b-5 has been well summarized by the Court of Appeals for the Second Circuit:[111]

> [A] requirement of privity was at first suggested ... but has more recently been ignored .... However, the search for limiting doctrine has continued. Thus, some courts have looked to see whether a plaintiff actually relied on the allegedly fraudulent statement, whether such reliance was reasonable, whether the fraud actually caused harm to the plaintiff, whether the plaintiff's injury was foreseeable, and whether plaintiff falls within the category of buyer or seller of securities.[112]

This subsection will consider briefly the application of these various limiting doctrines to a violation of 10b-5 occurring in connection with an indirect or market transaction.

1. Causation and Reliance

In *Barnett v. Anaconda Co.*,[113] the court stated that in order to sustain a claim under section 10(b) there must be "at least some causal relationship to the damage complained of."[114] It has been suggested, though not held, that the causal relationship should be one of proximate cause.[115] Whether characterized as proximate cause or not, the question of causation is one of ultimate fact.[116]

Without any further refinement of the test of causation, a finding of a causal relationship between a person who violates Rule 10b-5 by nondisclosure or selective disclosure of inside information in connection with a market transaction and a person who has traded the stock in the same market would be difficult at best, because in an indirect transaction there is no face-to-face contact or communication between plaintiff and defendant.

In *List v. Fashion Park, Inc.*[117] the court did refine the test of causation when it discussed the requirement that reliance be placed on the misrepresentation in a civil suit under Rule 10b-5.[118] After equating the reliance requirement with the principle of causation in fact,[119] the court set forth the following test: "[T]he proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the

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[111] Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967).

[112] *Id.* at 543-44 (citations and footnotes omitted); *see also* section IV(B) *supra.*

[113] 238 F. Supp. 766 (S.D.N.Y. 1965).

[114] *Id.* at 775. *See also* West v. Zurhorst, 280 F. Supp. 574, 580 (S.D.N.Y. 1967); Globus, Inc. v. Jaroff, 271 F. Supp. 378, 381 (S.D.N.Y. 1967); Miller v. Steinbach, 268 F. Supp. 255, 279 (S.D.N.Y. 1967). *Cf.* Weber v. Bartle, 272 F. Supp. 201, 204 (S.D.N.Y. 1967).

[115] Smith v. Bear, 237 F.2d 79, 88 (2d Cir. 1956); Barnett v. Anaconda Co., 238 F. Supp. 766, 775 n.6 (S.D.N.Y. 1965).

[116] West v. Zurhorst, 280 F. Supp. 574, 580 (S.D.N.Y. 1967).

[117] 340 F.2d 457 (2d Cir. 1965).

[118] *Id.* at 463.

[119] *Id.*

undisclosed fact."[120] This test has been followed by a number of courts,[121] and although it was originally formulated in a direct transaction case, its potential application to an indirect transaction case would not be beyond the bounds of logic: If the duty upon an insider or tippee trading in a security is to make his inside information public,[122] and the plaintiff can show that he would have acted

[120] *Id.* (citations omitted). This test has been characterized as a constructive reliance test, applicable to cases of nondisclosure. That is, plaintiff *would have* relied *had* he been informed. Note, *Insider Trading on the Open Market: Nondisclosure and Texas Gulf Sulphur,* 42 S. CAL. L. REV. 309, 322 (1969).

It has been suggested that the court did not properly phrase its test question. "[W]hat the court should have been asking in *List* was whether the plaintiff would have sold if defendants had refrained from trading, not whether he would have sold if defendants had disclosed." Note, *Insiders' Liability Under Rule 10b-5,* 78 YALE L.J. 864, 871 (1969). This attack on the test is derived from the premise that the "formula's basic defect is its implicit assumption that insiders are subject to an unconditional duty to disclose." *Id.* at 870. Although this attack on the *List* test is appropriate in some fact situations, the situation under consideration here involves selective disclosure rather than partial disclosure or nondisclosure. *See* note 124 *infra.* The fact that selective disclosure is involved has significance for two reasons. First, it establishes an apparent violation of at least the Rule's intent to have all segments of the investing public equally informed. Second, such selective disclosure should take away any defense based on the business judgment rule's implication that total secrecy is a matter for determination by the corporation without interference from the courts. Clearly these business reasons that dictate secrecy cannot be agued to exist if part of the public has already been told. *See* Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity,* 74 YALE L.J. 658, 677 (1965). Although the *List* test may assume the disclosure requirement, if the duty to disclose exists independently of the test, the test should be applicable.

[121] *See, e.g.,* Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967); Vanderboom v. Sexton, 294 F. Supp. 1178, 1193 (W.D. Ark. 1969).

[122] *See* note 120 and text accompanying note 55 *supra.* The recent case of *Reynolds v. Texas Gulf Sulphur Co.,* CCH FED. SEC. L. REP. ¶ 92,494 (Civil No. 132-66) (D. Utah Oct. 16, 1969), appears to support the conclusion that the *List* test can be applied to cases of nondisclosure in connection with indirect transactions, where a duty to disclose can be found. In considering the claims of Plaintiff Karlson, the court said:

> Plaintiff Karlson sold his stock on December 11, 1963, through a stock exchange. There was no face-to-face transaction. Fogarty did not purchase the particular shares sold by Karlson. While it is not necessary for Karlson to establish privity of contract in order to recover for violations of the statute or rule, and the fact that there was a total non-disclosure would not prevent recovery if some form of manipulation was involved [citing *List v. Fashion Park, Inc.*], it nevertheless is necessary for Karlson to prove some causative connection between Fogarty's actions or omissions and the damage Karlson claims he suffered. The court finds no such causative effect.

Id. at 98,314 (footnotes omitted). The court goes on to explain the lack of causation in terms of the fact that the duty which the corporation owes to its stockholders to keep them reasonably informed as to corporate affairs does not surpass all other duties owed to stockholders: For instance, the duty to not make information concerning the mineral discovery public until the company could first protect itself by acquiring mineral interests in adjoining lands. The court concluded that "it is not necessary to pass upon the materiality of the information available to defendants on December 11, 1963, because of his findings that there was *no duty* at that time on the part of either defendant to disclose the information then available with respect to drilling results, and that Fogarty's violations of the statute and the rule by purchasing TGS stock did not cause any damage to Plaintiff Karlson." *Id.* at 98,314 (emphasis added). Although the court denied recovery to Plaintiff Karlson for nondisclosure where there was no duty to disclose, other plaintiffs in this case recovered on the basis of the false and misleading press release issued in connection with the indirect transactions involved in the case. *Id.*

differently than he did had he been informed prior to his market transaction, then it can be said that the defendant's failure to disclose the information — his violation of 10b-5 — caused the injury to plaintiff.

2. Privity or "Semblance" Thereof

Few cases, however, have actually sustained a private cause of action for a violation of Rule 10b-5 in connection with an indirect or market transaction, and judges faced with a claim that 10b-5 liability should be imposed in indirect transactions have wrestled with the requirement of privity or a "semblance" thereof.

In one such case, *Drake v. Thor Power Tool Co.*,[123] the situation was that the plaintiff's claim involved misrepresentation by false or misleading statements in connection with an indirect transaction, rather than selective disclosure[124] or nondisclosure of material inside information. The court dismissed the privity requirement but appeared to rely on the fact that the alleged misstatements (financial statements) *were intended for public information and to induce the public to buy securities.*[125] The court also found reliance on the alleged misstatements and concluded that the registrant's accounting firm could be liable regardless of whether it had benefited from the supposedly inflated market price.[126]

It is possible to suggest that privity, or rather a "semblance" thereof, deserves rehabilitation as a limiting doctrine in the context of indirect or market transactions. Professor Bloomenthal discusses, with reference to the "faceless" transaction, the relationship of a defendant's *intent to induce action* to the requirement of privity in terms of foreseeability:

> The key to what the [United States District Court for the Southern District of New York, per Judge Sugarman, speaking in *Joseph v. Farnsworth Radio & Television Corp.*,[127]] meant by "semblance of privity" can perhaps be found in its quotation from Judge Frank's opinion in [*Fischman v. Raytheon Mfg. Co.*,[128]] suggesting that the plaintiff amend his complaint so as to allege that the corporation made false statements for the purpose of inducing the plaintiffs to purchase the common stock in the market. On this basis the

[123] 282 F. Supp. 94 (N.D. Ill. 1967).

[124] It should be noted that there is a difference between selective and partial disclosure. *Selective* disclosure is disclosure of information to some but not all, while *partial* disclosure is a disclosure of some but not all facts to the same person or persons. The former is akin to nondisclosure in that the public is denied information provided to select individuals; the latter is the substance of a 10b-5 violation in that the partial nondisclosure makes the disclosed information false or misleading.

[125] Drake v. Thor Power Tool Co., 282 F. Supp. 94, 104 (N.D. Ill. 1967).

[126] *Id.* at 104-05.

[127] 99 F. Supp. 701 (S.D.N.Y.), *aff'd* 198 F.2d 883 (2d Cir. 1952).

[128] 88 F.2d 783, 788 (2d Cir. 1951).

> required semblance of privity would be present if the issuer or insiders made false statements which they intended to (or could have foreseen would) be relied upon by others purchasing the security in the market even though the issuer or insiders themselves were not selling the particular shares being purchased. Conceiveably, this could be extended to cover the failure to disclose material information and could be equally applicable to false or misleading statements or failure to disclose material facts intended to (or which could have been foreseen would) induce persons to sell the particular security.[129]

Joseph v. Farnsworth Radio & Television Corp., much cited — and maligned[130] — for its requirement that 10b-5 liability cannot be found in the absence of at least a "semblance of privity," may actually be enunciating a requirement which is not practically differentiable from the classic requirement of proximate cause connecting a plaintiff's loss and the misrepresentation of defendant. According to Prosser,

> [T]he damage upon which a deceit action rests must have been "proximately caused" by the misrepresentation. So far as the fact of causation is concerned, any loss which follows upon a transaction into which the misstatement induces the plaintiff to enter may be said to be caused by it; but the same *considerations which limit liability* in cases of tangible harm have operated here. In general, with only a few execptions, the courts have restricted recovery to those *damages which might foreseeably be expected to follow from the character of the misrepresentation itself.*[131]

Analogizing the Federal tort law of Rule 10b-5 to the common law of deceit, the *List* test of reliance — *would* the plaintiff have acted differently, *if* he had known[132] — can be seen as a formulation for causation in fact. The *List* test, however, is conceivably over-

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[129] H. BLOOMENTHAL, SECURITIES LAW 600 (1966).

Professor Loss' most recent comment regarding "privity" is worthy of note:

> Again, more and more under the impact of *Texas Gulf* and *Heit v. Weitzen,* on which the Supreme Court denied certiorari the other day, and similar cases, we have a great problem that nobody can answer today: the unexplored consequences of imposing liability on corporate insiders to the market generally, without regard to traditional notions of privity. I know it's fashionable for law professor's particularly to pooh-pooh privity as a concept in deceit, and I have done it along with others, but when you abandon the privity concept and make a director or officer liable to everybody who has bought or sold in the market because there is a false press release or a false report, or something of that sort, the potential liability is, really, quite horrendous in relation to the crime, if it be a crime.

Loss, *The American Law Institute's Federal Securities Code Project,* 25 BUS. LAW. 27, 35 (1969) (citations omitted).

[130] In *Miller v. Bargain City, U.S.A., Inc.,* 229 F. Supp. 33, 37 (E.D. Pa. 1964), Judge Lord, in speaking of the *Farnsworth* decision, said: "The language of the district court in that case was: ' . . . . A semblance of privity . . . seems to be requisite . . . .' I find it unnecessary to attempt a definition of this, at best, cloudy phrase, for if 'a semblance of privity' means 'privity' (like 'a little bit pregnant'), I reject it."

[131] W. PROSSER, LAW OF TORTS 748 (1964). *See also* Palsgraf v. Long Island R.R. Co., 248 N.Y. 339, 162 N.E. 99 (1928).

[132] *See* note 120 *supra* and accompanying text.

broad. It is well enough to concentrate on reliance or causation alone in cases where foreseeability and privity are never mentioned because they are not a problem. In such cases — cases involving direct transactions — one is dealing with people whose relationship to defendant's action is clear and direct. However, difficulties arise in attempting to go from those cases to cases of faceless, indirect nondisclosure (or selective disclosure). In the latter cases the *List* test could be answered in the affirmative by almost anybody. It is suggested that the *List* test of reliance is not overbroad, however, if a foreseeability test — *Farnsworth's* "semblance of privity" — is coupled with it. This "semblance of privity" requirement, thus understood, may, needless to say, bear less kinship to the classic concept of privity of contract than it bears to the classic concept of foreseeability, viewed as an element of proximate or legal cause in the law of torts.[133] In any event, it should not be overlooked as an available, and arguably appropriate, limiting doctrine in a context where application of now established 10b-5 law in connection with an indirect transaction might raise the specter of unlimited liability to an unlimited class of plaintiffs. Moreover, it is also suggested that limiting the *extent* of liability, an arguably valid consideration,[134] should not be so regarded as to preclude liability altogether.[135]

3. Persons Who May be Liable in Indirect Transactions

This subsection has not analyzed civil liability for violations of 10b-5 in terms of the three classifications of persons described in section I *supra* — corporate insiders, first generation tippees, and second generation tippees. It has been assumed for purposes of this subsection that, if a violation were found on the part of a member of any of these categories, concepts of causation, reliance and foreseeability would apply equally to each class of violators.[136] It would seem that the legal criteria for determining a violation on the one hand, and civil liability via causation, reliance and foreseeability, on the other, ought to operate more or less independently.

E. *Civil Liability for Tipping*

The original question posed at the beginning of the Note is, Can civil liability be imposed on one who "tips" — *i.e.*, selectively discloses material inside information to one who thereafter trades

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[133] For the suggestion that proximate cause ought to be required in 10b-5 cases see, Smith v. Bear, 237 F.2d 79, 88 (2d Cir. 1956); Barnett v. Anaconda Co., 238 F. Supp. 766, 775 n.6 (S.D.N.Y. 1965).

[134] The courts view underwriting in its present form to be vital to the growth of American industry. *See* United States v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1953).

[135] For a discussion of alternative limitations on *extent of liability,* see p. 480 *infra.*

[136] Such a conclusion was reached in section IV(C)(4) *supra.*

in the security in question? If so, under what circumstances can the tipper be held liable, and to what extent?

The aspect of this question which has not been considered is whether a person with inside information can be held *civilly liable* for tipping.

It has been established that tipping is itself a violation of the Rule.[137] However, no case has yet imposed civil liability for tipping.[138] This subsection will consider various theories by which the legal conclusion that civil liability might be imposed for tipping might be reached.

1. Violation Plus Causation and Reliance

An orthodox theory that civil liability should exist whenever a 10b-5 violation occurs which causes the injury of another does not on its face appear to be unreasonable. Applying the *List* test of reliance,[139] the problem of proving reliance and causation and perhaps foreseeability as well, should not be impossible for a prospective plaintiff. There are two problems, however, which should be considered.

First, the tipper did not trade in the stock in question. Rule 10b-5 requires that the prohibited acts be performed "in connection with" a purchase or sale of securities.[140] This problem, however, is one inherent in finding a *violation* of the Rule, and it has been assumed for purposes of this discussion that tipping *is* a violation.[141] It is also probable that the tipper's tippees will have traded in the stock,[142] thus providing a "connection" with a transaction, and, even if they have not, it is possible to view the plaintiff's purchase or sale which was "caused" by the tipper's selective disclosure as sufficiently "connected with" the tipper's actions to establish a violation.

The second problem is that any damages which were sustained did not accrue to the benefit of the tipper — but rather accrued to the benefit of the tipper's tippees.[143] Although this may be a legitimate objection, at least one case has sustained civil liability

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[137] *See* text accompanying note 43 *supra.*

[138] Bromberg, *TGS, supra* note 21, at 746. For the nearest case so holding, see Ross v. Licht, 263 F. Supp. 345 (S.D.N.Y. 1967), *noted in* 70 STAN. L. REV. 347 (1968).

[139] *See* note 120 *supra* and accompanying text.

[140] *See* text of Rule quoted in text accompanying note 16 *supra.*

[141] *See* text accompanying note 137 *supra.*

[142] According to Bromberg, "there can hardly be liability unless it [tipping violation] results in some damage, *e.g.*, through trading by the tippees." Bromberg, *TGS, supra* note 21, at 746.

[143] If the tipper is himself a tippee, then *his* tippees would be subsequent generation tippees.

in the face of the objection. In *Drake v. Thor Power Tool Co.*,[144] the court, after rejecting the privity requirement, said, "[d]efendant Peat, Marwick, in independently auditing Thor's financial statement, remains liable regardless of whether it had benefited from the supposedly inflated market price. The position of an independent auditor is different from that of other corporate insiders."[145] Although the position of an independent auditor may be different from that of an underwriter, for instance, or that of a tippee who tips, the cases holding independent auditors liable for fraudulent disclosure or nondisclosure may provide initial theoretical justification for holding someone liable who does not directly benefit from his tortious conduct.[146] The problem should be one of determining what sort of duty is owed to the public by one possessed of inside information.

2. Aiding and Abetting

Another theory of liability applicable to cases involving tipping is that of "aiding and abetting." This concept has evolved from the law of torts and has been applied in 10b-5 cases.[147] The statement of the theory was borrowed from the *Restatement of Torts:* "For harm resulting to a third person from the tortious conduct of another, a person is liable if he . . . (b) [k]nows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself . . . ."[148]

The application of this theory to a set of facts can best be seen in the case of *Brennan v. Midwestern United Life Ins. Co.*[149] In that case, replete with a complex set of facts, the defendant insurance company was found to be an aider and abettor to a fraudulent securities broker dealing in its stock, by referring potential customers to the broker while knowing of the broker's fraudulent dealings. The court found "that MULIC [Midwestern United Life Ins. Co.] engaged in an *affirmative* course of conduct which aided and abetted Dobich's violations of Section 10(b) and Rule 10b-5."[150] The de-

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144 282 F. Supp. 94 (N.D. Ill. 1967).

145 *Id.* at 104-05.

146 For another case involving the 10b-5 civil liability of an accounting firm who did not trade in the securities in question but *failed to disclose* certain after-acquired information relevant to a financial statement, see *Fischer v. Kletz,* 266 F. Supp. 180 (S.D.N.Y. 1967). Here the court sustained liability on the basis of an "aiding and abetting" theory.

147 Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 708 (N.D. Ind. 1968). *See also* Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967); Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967); Pettit v. American Stock Exchange, 217 F. Supp. 21 (S.D.N.Y. 1963); Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955).

148 RESTATEMENT OF TORTS § 876 (1939).

149 286 F. Supp. 702 (N.D. Ind. 1968).

150 *Id.* at 708 (emphasis added).

fendant argued that it could not be liable for plaintiff's damages because such damages would have occurred despite defendant's conduct. The court rejected this argument stating that the notion "that liability might . . . result from aiding and abetting a violation of Section 10(b) and Rule 10b-5 — has continued to find acceptance in the courts."[151] Finally, the court observed that defendant could also be found guilty of aiding and abetting by mere failure to report the broker's fraudulent activities to the Indiana Securities Commission.[152]

Analogizing the reasoning of the *Brennan* case to the situation of an insider or tippee tipping another leads to a theory of liability for tipping in certain circumstances. Where the insider or tippee tips and pursues an affirmative course of conduct[153] in assisting *his* tippee (or second generation tippee) in violating the Rule,[154] or fails to report his tippee to proper authorities when he knows the latter is violating the Rule, the tipper would be liable as an aider and abettor of his tippee's violation. The application of this theory of liability "cannot be confined to an abstract rule but must be fashioned case by case as particular facts dictate."[155]

3. Vicarious Liability

Professor Bromberg has suggested another theory for holding a person civilly liable as a tipper. His suggestion is analogous to vicarious liability for tipping:

> Although tipping is itself a violation [of Rule 10b-5], there can hardly be any liability unless it results in some damage, *e.g.*, through trading by the tippees. Given the nature of the financial world, an insider who tips a friend should probably be charged with *foreseeing* the friend will tell one or two others and that the information will continue to spread. Quite conceivably he will be liable for all the trades which can be traced to information emanating from him. In the abstract, there is reason to hold the original tipper even for trades by tippees which — because of the muted form in which the information reaches the tippees — are not violations by them. If the overriding policy is to prevent informational inequities in the market, it would be served by such a rule, which would also operate as a powerful deterrent to tipping.[156]

The theory rests on the tort principle of foreseeability, and would probably require proof of a chain of causation running from defendant to plaintiff. If a test of factual causation were to be employed,

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[151] *Id.* at 725.

[152] *Id.* at 727.

[153] It may be suggested that the mere act of "tipping" is sufficient "affirmative conduct" to establish this element of aiding and abetting

[154] For a discussion of first and second generation tippee violations of 10b-5, *see text* sections I(B-C) *supra.*

[155] Kohler v. Kohler Co., 319 F.2d 634, 637-38 (7th Cir. 1963).

[156] Bromberg, *TGS, supra* note 21, at 746 (footnotes omitted) (emphasis added).

inequities might be prevented. Holding tippers liable for the actions of their tippees might have the benefit of discouraging all forms of dissemination of information in violation of the Rule, because the sources of the information would be deterred from divulgence.[157] While there is merit in holding a tipper liable in a private action, care should be taken to assure that a defendant is not held liable where his action (in disclosing or not disclosing) is innocent and could result in no foreseeable harm.

CONCLUSION

The question raised at the beginning of this Note is, Can civil liability be imposed on one who "tips" — *i.e.,* selectively discloses material inside information to one who thereafter trades in the security in question? If so, under what circumstances can the tipper be held liable, and to what extent?

The answer to this question is that no court has ever so held, but the theoretical framework exists which would rationally justify such a holding, even where the tipper's tippees traded in an indirect transaction.

First, it was concluded that a first generation tippee could be held civilly liable for a violation of 10b-5, at least for a violation involving trading in a direct transaction. Once a trading violation of Rule 10b-5 has been established, the status of a person as an insider, first generation tippee, or subsequent generation tippee should not ordinarily be relevant to the question of imposing civil liability on the person for his violation. The status of a violator does become relevant, however, in considering the question of imposing civil liability for a tipping violation. The three theories by which a "tipper" could possibly be held civilly liable — causation and reliance, aiding and abetting, and vicarious liability — seem to suggest that the tipper's liability depends upon *his* tippee's violation of 10b-5. Although this reasoning is not absolutely necessary to the causation and reliance liability approach, such reasoning would raise the problem of determining a violation by the tipper's tippee. If the tipper is *himself* a tippee, then his "subsequent generation tippee" would have to be found in violation of 10b-5.

A second problem arises in attempting to hold a tipper liable for his tippee's violation, if the tipper's tippee (or second generation tippee) has traded in an indirect transaction. It was concluded, however, that existing notions of causation, reliance and foreseeability, as well as the meager authority addressing the issue, would not be offended by imposing civil liability on the basis of an indirect

[157] *Failure to Disclose, supra* note 20, at 357.

transaction, particularly if some limiting notion such as proximate cause were retained.

Although no court has yet held an insider or tippee liable for tipping — selectively disclosing material inside information to subsequent generation tippees who trade the securities in question in an indirect or market transaction — such a legal conclusion does not seem to be beyond the realm of possibility or sound reasoning. The major objection to such a holding is that the potential liability could be unconscionable — unlimited liability to an unlimited number of plaintiffs.

However, it is suggested that considerations regarding the *extent* of liability should not necessarily preclude liability itself, so long as there are alternative limitations on the extent of liability.

Several factors bearing on the damages question might be considered to reduce the extent of liability so that the total potential recovery by all plaintiffs would be one which a court could countenance.[158]

A court could:

(1) Include only the plaintiff's measure of actual damage losses on shares bought during days when subsequent generation tippees sold, and limit the number of shares upon which recovery could be based to the number the subsequent generation tippees sold each day or the number plaintiff bought that day, whichever was greater;

(2) Require that the damages question be decided in an action wherein the subsequent generation tippees were joined as parties, but only require for the plaintiff to recover a showing that the subsequent generation tippees traded in the relevant period, that they had received the tip, and that they had reason to know it was inside information. This would have the effect of mandatorily spreading the liability to more of the culpable parties without making the burden on plaintiff excessive.

(3) Limit recovery in the normal case to the amount of profit actually realized. Provisions for punitive re-

[158] An example of the method in which courts compute damages is the recent case in Utah based on the facts of the *Texas Gulf Sulphur* decision. Reynolds v. Texas Gulf Sulphur Co., CCH FED. SEC. L. REP. ¶ 92,494, (Civil No. 132-66) (D. Utah Oct. 17, 1969). In this case the court applied the "New York Rule" which determines that the measure of damages in a stock transaction is "the highest intermediate value reached by the stock between the time of the wrongful act complained of and a reasonable time thereafter, to be allowed to the injured party to place himself in the position he would have been in had not his rights been violated." The court determined a reasonable time to be 20 trading days, and then computed the average of the high market prices on those 20 days to arrive at a figure to compute damages. *Id.*

coveries could be provided to avoid the possibility of blatant violations without recourse in cases where no defendants made profits or the small profits made by the solvent defendants are inadequate compensation for plaintiff's loss in light of the nature and intent of defendant's violation.[159]

The question of damages should not, however, influence the question of liability. Persons, whether insiders or first generation tippees, who selectively disclose material inside information which they know will cause trading based on the information, should be held liable to those defrauded in the market by such a violation of Rule 10b-5. The more properly debatable question is to what extent should they be held liable?

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[159] But in connection with the suggestion that punitive damages should be allowed, see the arguably contrary holding in *Globus v. Law Research Service, Inc.*, [1967-1969 Transfer Binder] CCH FED. SEC. REP. ¶ 92,474 (S.D.N.Y. Sept. 9, 1969). indicating that punitive damages could not appropriately be allowed in an action based on alleged violations of section 17(a) of the Securities Act of 1933, which parallels Rule 10b-5 in many respects.

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COMMENT

CONSTITUTIONAL LAW — DUE PROCESS AND STATUTORY PRESUMPTIONS — SELF-INCRIMINATION AND MARIHUANA REGISTRATION REQUIREMENTS. — *Leary v. United States,* 395 U.S. 6 (1969).

ON December 22, 1965, Timothy F. Leary's attempt to enter Mexico was denied.[1] While returning to the United States, he was stopped and inspected at the American secondary inspection area and was found to have marihuana in his possession. He was subsequently convicted[2] of knowingly transporting marihuana into the United States[3] and of knowingly transporting marihuana without having paid the transfer tax.[4] On certiorari, the United States Supreme Court reversed on the basis that a presumptive provision of the importation statute[5] was not "rationally connected" with the facts of the case and was thus a denial of due process.[6] Also, the Court concluded that the *Marihuana Tax Act*[7] contained a " 'real and appreciable' hazard of incrimination"[8] resulting in a denial of Leary's fifth amendment privilege.[9]

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[1] Leary v. United States, 395 U.S. 6 (1969). Dr. Leary drove across the International Bridge where he was stopped by the Mexican authorities and after apparently being denied entry, he returned across the bridge to the United States.

[2] United States v. Leary, 383 F.2d 851 (5th Cir. 1967), *rehearing denied,* 392 F.2d 220 (1968).

[3] 21 U.S.C. § 176(a) (1964) provided:

> Notwithstanding any other provision of law, whoever, knowingly, with intent to defraud the United States, imports or brings into the United States marihuana contrary to law, or smuggles or clandestinely introduces into the United States marihuana which should have been invoiced, or receives, conceals, buys, sells, or in any manner facilitates the transportation, concealment, or sale of such marihuana after being imported or brought in, knowing the same to have been imported or brought into the United States contrary to law, or whoever conspires to do any of the foregoing acts, shall be imprisoned not less than five or more than twenty years and, in addition, may be fined not more than $20,000.

[4] 26 U.S.C. § 4744(a)(1) (1964) provides:

> (a) Persons in general.
>
> It shall be unlawful for any person who is a transferee required to pay the transfer tax imposed by section 4741 (a) — (1) to acquire or otherwise obtain any marihuana without having paid such tax, or (2) to transport or conceal, or in any manner facilitate the transportation or concealment of, any marihuana so acquired or obtained.

[5] 21 U.S.C. § 176(a) (1964).

[6] 395 U.S. at 33-36.

[7] 26 U.S.C. § 4744(a) (1964).

[8] 395 U.S. at 18.

[9] Justice Harlan delivered the opinion of the court in *Leary.* Justice Black concurred specially as to the due process issue and Chief Justice Warren and Justice Stewart concurred with reservation as to the issue of self-incrimination.

Chief Justice Warren felt himself bound by his dissents in *Marchetti v. United States,* 390 U.S. 39 (1968), *Grosso v. United States,* 390 U.S. 62 (1968), and *Haynes*

I. Due Process and Presumption

Due process, a bastion of protection against aribitrary use of power by the sovereign, is a concept that has been with us since the *Magna Charta*.[10] Though the concept has broadened, its meaning continues to be elusive — best understood within a specific context. Fundamental to the concept of due process is the presumptive innocence of an accused until proven guilty beyond a reasonable doubt, with the burden of establishing guilt resting upon the prosecution.[11] Theoretically then, the prosecution must prove all elements of a crime.[12] However, Congress often includes presumptions within a statute by which various elements of a crime are inferred from a central fact and by so doing lessens the prosecution's burden of proof.[13] Congress creates these presumptions for a number of reasons: (1) they may save time by focusing the courts attention on a central issue; (2) they may shift the burden of proof to the party with superior access to the facts; (3) they are procedurally more convenient; or (4) because of social or economic policies.[14] The effect

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v. United States, 390 U.S. 85 (1968). In *Grosso,* the Chief Justice stated that "by its sweeping declaration that the congressional scheme for enforcing and collecting the taxes imposed on wagers and gamblers is unconstitutional, the Court has stripped from Congress the power to make its taxing scheme effective." Grosso v. United States, 390 U.S. 62, 77 (1968).

Justice Stewart expressed the hope that some day the Court would reexamine the whole line of cases which has broadened the original conception of self-incrimination. Leary v. United States, 395 U.S. 6, 54 (1969).

[10] "The Crown or its ministers may not punish, imprison, or coerce the subject in an arbitrary manner." MAGNA CHARTA 1215 art. 39, from 7 HALSBURY'S LAW OF ENGLAND § 483 (3d ed. 1954).

[11] Speiser v. Randall, 357 U.S. 513, 524 (1958); United States v. Fleischman, 339 U.S. 349, 363 (1950); Holt v. United States, 218 U.S. 245, 253 (1910); Coffin v. United States, 156 U.S. 432, 459 (1895); Stump v. Bennett, 398 F.2d 111, 118 (8th Cir.), *cert. denied,* 393 U.S. 1001 (1968); Government of the Virgin Islands v. Torres, 161 F. Supp. 699, 700 (D.C.V.I. 1958).

[12] Morissette v. United States, 342 U.S. 246, 273-76 (1952); Christoffel v. United States, 338 U.S. 84, 89 (1949); Stump v. Bennett, 398 F.2d 111, 118-20 (8th Cir.), *cert. denied,* 393 U.S. 100 (1968); Pauldino v. United States, 379 F.2d 170, 172 (10th Cir. 1967); Thurmond v. United States, 377 F.2d 448, 451 (5th Cir. 1967); People *ex rel.* Juhan v. District Court, 439 P.2d 741, 747-50 (Colo. 1968).

[13] A presumption has been defined as follows: "A presumption is an assumption of fact resulting from a rule of law which requires such fact to be assumed from another fact or group of facts found or otherwise established in the action." UNIFORM RULES OF EVIDENCE rule 13 (1965). Extensive literature has developed concerning the nature and effect of presumptions: C. MCCORMICK, LAW OF EVIDENCE §§ 307-18 (1954); E. MORGAN, BASIC PROBLEMS OF EVIDENCE 31-44 (1963); J. THAYER, PRELIMINARY TREATISE ON THE LAW OF EVIDENCE AT THE COMMON LAW 313-52 1898); 9 J. WIGMORE, EVIDENCE §§ 2490-93 (3d ed. 1940); Brosman, *The Statutory Presumptions,* 5 TUL. L. REV. 17, 178 (1930); Morgan, *How to Approach Burden of Proof and Presumptions,* 25 ROCKY MT. L. REV. 34 (1953); Comment, 1964 DUKE L. J. 867; Note, 55 COLUM. L. REV. 527 (1955).

[14] Defendants of presumptions have gone to great lengths to provide rationale for the existence of these policies. *See* C. MCCORMICK, LAW OF EVIDENCE § 309 (1954); E. MORGAN, BASIC PROBLEMS OF EVIDENCE 32-33 (1963). *But see* Chamberlain, *Presumptions as First Aid to the District Attorney,* 14 A.B.A.J. 287 (1928).

of a presumption may be to force a party to come forth and give evidence or it may shift the burden of persuasion.[15]

The power of legislatures to create presumptions has long been recognized by the courts and is limited only by the dictates of the Constitution.[16] Consequently, a number of lines of attack on the constitutionality of presumptions has developed, notably in the areas of equal protection,[17] trial by jury,[18] self-incrimination,[19] and due process of law.[20]

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[15] This is a simplification of the basic effects of a presumption. Much discussion and debate has dealt with this issue, particularly regarding whether or not a presumption continues to have evidentiary effect once evidence as to the issue has been presented. Thayer and Wigmore have taken the position that once evidence comes out regarding the validity of the issue, the presumption drops out of the case and only has a procedural effect. *See* Laughlin, *In Defense of the Thayer Theory of Presumptions*, 52 MICH. L. REV. 195 (1953). This view was adopted by the American Law Institute in its MODEL CODE OF EVIDENCE rule 704(2) (1942). Other authorities feel that a presumption continues to have evidentiary effect even after some evidence to contradict the presumption has been brought forth. Morgan postulates eight gradients of effect that a presumption may take. E. MORGAN, BASIC PROBLEMS OF EVIDENCE 34-37 (1962).

[16] *See* Tot v. United States, 319 U.S. 463 (1943); United States *ex rel.* Shott v. Tehan, 365 F.2d 191 (6th Cir.), *cert. denied*, 385 U.S. 1012 (1966); Shaw v. United States, 357 F.2d 949 (Ct. Cl. 1966). *See generally* Brosman, *The Statutory Presumption*, 5 TUL. L. REV. 17, 178 (1930); Chamberlain, *Presumptions as First Aid to the District Attorney*, 14 A.B.A.J. 287 (1928); Keeton, *Statutory Presumptions—Their Constitutionality and Legal Effect*, 10 TEX. L. REV. 34 (1932).

[17] Presumptions cannot discriminate against a particular industry—McFarland v. American Sugar Refining Co., 241 U.S. 79 (1916); Lindsley v. Natural Carbonic Gas Co., 220 U.S. 61 (1911)—or race—Cockrill v. People, 268 U.S. 258 (1925). It has been established that although legislatures have a great deal of freedom in the making of presumptions, "[I]t is not within the province of a legislature to declare an individual *guilty* or *presumptively guilty* of a crime." Speiser v. Randall, 357 U.S. 513, 523-24 (1958) (emphasis added). *See also* McFarland v. American Sugar Refining Co., 241 U.S. 79 (1916); Stump v. Bennett, 398 F.2d 111 (8th Cir. 1968).

[18] Justice Black feels that presumptions can unconstitutionally deny a defendant trial by jury in that "it flaunts the constitutional power of courts and juries for Congress to tell them what shall be deemed sufficient evidence to authorize conviction.' " United States v. Gainey, 380 U.S. 63, 77 (1965) (dissenting opinion). *See also* People v. Lyon, 27 Hun 180 (N.Y. 1882); Wynehamer v. People, 13 N.Y. 378 (1856); State v. Papa, 32 R.I. 453, 80 A. 12 (1911); State v. Beswick, 13 R.I. 211 (1883); Francis v. Baker, 11 R.I. 103 (1875); Plimpton v. Somerset, 33 Vt. 283 (1860). *Contra, see generally* Amerada Petroleum Corp. v. 1010.61 Acres of Land, 146 F.2d 99 (5th Cir. 1944).

[19] Justice Black has said that: "The undoubted practical effect of letting guilt rest on unexplained presence alone is to force a defendant to come forward and testify.... The compulsion here is of course more subtle and less cruel physically than compulsion by torture, but it is nonetheless compulsion and it is nonetheless effective." United States v. Gainey, 380 U.S. 63, 87 (1965) (dissenting opinion).

The issue of whether presumptions create self-incrimination has been raised before the courts a number of times unsuccessfully. *See* Yee Hem v. United States, 268 U.S. 178 (1925); United States v. Forgett, 349 F.2d 601 (6th Cir. 1955); Ng Choy Fong v. United States, 245 F. 305 (9th Cir. 1917); People *ex rel.* Woronoff v. Mallon, 166 App. Div. 840, 150 N.Y. Supp. 705 (1914), *aff'd*, 222 N.Y. 456, 119 N.E. 102 (1918); State v. Humphrey, 42 S.D. 512, 176 N.W. 39 (1920).

[20] The due process requirements have followed two fundamental paths: (1) the necessity of a rational connection between the fact presumed and the fact proved—*see* Leary v. United States, 395 U.S. 6 (1969); United States v. Romano, 382 U.S. 136 (1965); United States v. Gainey, 380 U.S. 63 (1965); Tot v. United States, 319 U.S. 463 (1943)—and; (2) the unfairness of placing the burden of proof on the defendant as to a particular issue. "[T]he burden of going forward with the evidence at some stage of a criminal trial may be placed on the defendant, but only after the State has 'proved enough to make it just for the defendant to be required to repel what has been proved with excuse or explanation....' " Speiser v. Randall, 357 U.S. 513, 524

The most successful ground of attack on legislative presumptions has probably been that of due process where a "rational connection" between the established facts and the facts presumed is required.[21] Although not the first Supreme Court decision to apply this test, *Tot v. United States* clearly established the "rational connection" test as the controlling rule.[22] In *Tot,* the Court invalidated section 902(f) of the *Federal Firearms Act,* which made it a presumption that a firearm was unlawfully transported from the fact that a felon or fugitive had a firearm in his possession.[23] The court said:

> A statutory presumption cannot be sustained if there be no rational connection between the fact proved and the ultimate fact presumed .... [W]here the inference is so strained as not to have a reasonable relation to the circumstances of life as we know them, it is not

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(1958), *quoting from* Morrison v. California, 291 U.S. 82, 88-89 (1934). *See also* Morrison v. California, 291 U.S. 82 (1934); Rossi v. United States, 289 U.S. 89 (1933); Yee Hem v. United States, 268 U.S. 178 (1925); Shaw v. United States, 357 F.2d 949 (Ct. Cl. 1966); Communist Party v. United States, 331 F.2d 807 (D.C. Cir. 1963).

It was once held that the burden of proof could be shifted so long as it didn't subject "the accused to hardship or oppression." Morrison v. California, 291 U.S. 82, 89 (1933). However, it seems it would be impossible to find a criminal case where the shift in the burden of proof would not work to the disadvantage of the accused. *See* Tot v. United States, 319 U.S. 463 (1943).

[21] *See, e.g.,* Leary v. United States, 395 U.S. 6, 33 (1969); *see also* United States v. Romano, 382 U.S. 136 (1965); Tot v. United States, 319 U.S. 463 (1943); McFarland v. American Sugar Refining Co., 241 U.S. 79 (1916); Barrett v. United States, 322 F.2d 292 (5th Cir. 1963); Garcia v. United States, 250 F.2d 930 (10th Cir. 1957); Minski v. United States, 131 F.2d 614 (6th Cir. 1943); United States v. Platt, 31 F. Supp. 788 (S.D. Tex. 1940); United States *ex rel.* Murphy v. Warden of Clinton Prison, 29 F. Supp. 486 (N.D.N.Y. 1939), *aff'd,* 108 F.2d 861 (2d Cir. 1940), *cert. denied,* 309 U.S. 661, (1940), *rehearing denied,* 309 U.S. 696 (1940).

[22] 319 U.S. 463 (1943). There are a number of very early cases which applied the rational connection test. *E.g.,* Robertson v. People, 20 Colo. 279, 38 P. 326 (1894); Manley v. State, 166 Ga. 563, 144 S.E. 170 (1928), *reversed on other grounds,* 279 U.S. 1 (1929); State v. Beach, 147 Ind. 74, 43 N.E. 949 (1896); People v. Cannon, 139 N.Y. 32, 34 N.E. 759 (1893). Later, rational connection was considered as an optional test applied in conjunction with other tests. *See* Morrison v. California, 291 U.S. 82 (1934); Ferry v. Ramsey, 277 U.S. 88 (1928) (dissenting opinion); Mobile, Jackson & Kansas City R.R. v. Turnipseed, 219 U.S. 35 (1910).

One such test, the comparative convenience, or balance of convenience test, determined whether or not it would be more convenient for the defendant to produce the evidence. *See* Morrison v. California, 291 U.S. 82 (1934); Yee Hem v. United States, 268 U.S. 178 (1925). Although never altogether abandoned, the comparative convenience test was later relegated to a mere "corollary" test. Tot v. United States, 319 U.S. 463, 467 (1943).

Similarly, the Court once considered whether or not the legislature might have considered the presumed act to be a crime. *See* Ferry v. Ramsey, 277 U.S. 88 (1928). *But see* United States v. Romano, 382 U.S. 136, 144 (1965); Tot v. United States, 319 U.S. 463 (1943).

[23] Tot v. United States, 319 U.S. 463 (1943), *noted in* 56 HARV. L. REV. 1324 (1943); 17 S. CAL. L. REV. 48 (1943). The Federal Firearms Act, 15 U.S.C. § 902(f) (1964) provided that:

> It shall be unlawful for any person who has been convicted of a crime punishable by imprisonment for a term exceeding one year or [who] is a fugitive from justice to receive any firearm or ammunition which has been shipped or transported in interstate or foreign commerce, and the possession of a firearm or ammunition by any such person shall be presumptive evidence that such firearm or ammunition was shipped or transported or received ... by such person in violation of this chapter.

competent for the legislature to create it as a rule governing the procedure of courts.[24]

Some courts have applied the rational connection test with great exactitude,[25] others merely using it in a broad, rhetorical context.[26] Furthermore, the rule has been subject to criticism because of its lack of clarity (*e.g.*, who makes the rational connection — judges, juries, mankind, or possibly some other independent standard?).[27] Also, a confusing aspect, but essential to the question, is how strong an inference is necessary to sustain the presumption as constitutional — a mere inference, a preponderance of evidence, a substantial assurance, or proof beyond a reasonable doubt?

By considering the facts and language of recent Supreme Court decisions one finds clues as to what the test means today. In *United States v. Gainey*,[28] the Court upheld a presumption that one who was found in the presence of a still was "carrying on" the business of illegal distillation.[29] Although it is possible to be in the vicinity of illegal conduct without being involved, the Court felt the inference was permissible because: (1) the statute is broadly worded in that it encompasses a large class of persons who are involved or connected with the illegal activities;[30] and (2) "strangers to the illegal business rarely penetrate the curtain of secrecy."[31]

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[24] Tot v. United States, 319 U.S. 463, 467-68 (1943). *Cf.*, Leary v. United States, 395 U.S. 6 (1969); United States v. Romano, 382 U.S. 136 (1965); United States v. Gainey, 380 U.S. 63 (1965). It appears that there are two tests implicit within this rule; (1) there must be a rational connection, and (2) the inference must not be strained. The courts, however, have put the emphasis on the first and more stringent portion of the rule. *See* Leary v. United States, 395 U.S. 6 (1969); United States v. Romano, 382 U.S. 136 (1965); United States v. Gainey, 380 U.S. 63 (1965).

[25] *See* United States v. Margeson, 259 F. Supp. 256 (E.D. Pa. 1966); Government of the Virgin Islands v. Torres, 161 F. Supp. 699 (D.C.V.I. 1958).

[26] *See* People v. Scott, 24 Cal. 2d 774, 151 P.2d 517 (1944); State v. Grinnett, 33 Idaho 203, 193 P. 380 (1920); State v. Spiller, 146 Wash. 180, 262 P. 128 (1927); Brosman, *The Statutory Presumption*, 5 TUL. L. REV. 17, 178 (1930); Note, 55 COLUM. L. REV. 527 (1955).

[27] *See* Note, 55 COLUM. L. REV. 527 (1955). The test has been faulted because it is called a rational connection test whereas it is really an inferential test. *Id.*

[28] 380 U.S. 63 (1965), *noted in* 51 A.B.A.J. 482 (1965); 33 GEO. WASH. L. REV. 1137 (1965); 79 HARV. L. REV. 159 (1965); 27 MONT. L. REV. 216 (1966). Gainey was apprehended late at night as he approached the still, flashlight in hand. He was surprised by revenue agents and attempted to flee, but was caught after a short chase.

[29] *Id.* at 67. 26 U.S.C. § 5601(b)(2) (1964) provides:

> Whenever on trial for violation of subsection (a)(4) the defendant is shown to have been at the site or place where, and at the time when, the business of a distiller or rectifier was so engaged in or carried on, such presence of the defendant shall be deemed sufficient evidence to authorize conviction, unless the defendant explains such presence to the satisfaction of the jury (or of the court when tried without jury).

[30] 26 U.S.C. § 5601(a)(4) provides: "Any person who . . . carries on the business of a distiller or rectifier without having given bond as required by law . . . shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, for each such offense."

[31] 380 U.S. at 67-68 (1965). The Court also noted that the circuit courts had differed as to the significance of one's presence at a still and thus the question was proper for legislative determination. *Id.* at 67. *See also* Bozza v. United States, 330 U.S. 160 (1947); United States v. Freeman, 286 F.2d 262 (4th Cir. 1961).

In *United States v. Romano*,[32] a similar case involving a still, decided a few months after *Gainey*, the Court came to a different conclusion. The Court considered the question of whether possession, custody, or control can be inferred from mere presence at the site of an illegal still, and concluded that "[p]resence is relevant and admissible evidence in a trial on a *possession* charge; but absent some showing of the defendant's function at the still, [such presence] is too tenuous to permit a reasonable inference of guilt. . . ."[33] The Court, in *Romano*, distinguished *Gainey* on the basis that section 5601 (a)(1), is narrow in scope, addressing itself to "only one of the various aspects of the total undertaking,"[34] whereas *Gainey* involved a violation of section 5601(a)(4), a "sweeping prohibition of carrying on a distillation business."[35] That is, the prohibition against "carrying on" the business is aimed at a broad category of persons (*e.g.*, those in supply, delivery, or operational activities as well as those having possession and/or control), while the statute enjoining "possession, custody or control" affects a mere subclass of the former.[36] It is more probable that one who is present at a still is "carrying on" the business because of the large number of persons in this category. Thus, it appears, the Court will scrutinize carefully the language of the applicable statute with a view toward determining the breadth of its application, particularily where the offense is defined narrowly and the presumption seems far afield.

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[32] 382 U.S. 136 (1965), *noted in* 52 A.B.A.J. 82 (1966), *and* 8 WM. & MARY L. REV. 164 (1966). Romano was apprehended when federal authorities, armed with a search warrant, surprised the defendant and found him standing a few feet from an operating still.

[33] 382 U.S. at 141 (emphasis added). A number of circuit courts had already concluded that something more than presence at a still was necessary to prove possession. *See* Pugliese v. United States, 343 F.2d 837 (1st Cir. 1965); McFarland v. United States, 273 F.2d 417 (5th Cir. 1960); Vick v. United States, 216 F. 2d 228 (5th Cir. 1954); Graceffo v. United States, 46 F.2d 852 (3d Cir. 1931).

[34] United States v. Romano, 382 U.S. 136, 141 (1965).

[35] *Id.* at 140. 26 U.S.C. § 5601(a)(1) (1964) provides that: "Any person who . . . [h]as in his possession or custody, or under his control, any still or distilling apparatus set up which is not registered, as required by section 5179 (a) . . . shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, for each such offense."

Compare 26 U.S.C. § 5601(a)(4) (1964) *supra* note 30.

Judicial determination of whether a statute is broad or narrow in effect sometimes seems like speculation into the mysteries of the unknown, though it seems that more people would fit into the category of carrying on the business than would fit into the categories of possession, custody, or control. For one such speculation see *Vukich v. United States*, 28 F.2d 666 (9th Cir. 1928).

[36] Both categories are quite broad in light of the fact that accessories come within the statute and are treated as principals. 18 U.S.C. § 2 (1964) provides that:

> (a) Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal.
>
> (b) Whoever willfully causes an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.

Although the Court's distinction based on breadth of the applicable statute has logical validity, an alternative interpretation is that the Court is today applying the test in a more critical fashion.[37] The very fact that it drew such a fine distinction may be an indication that the Court has begun to move toward a more strict application of the *Tot* rule.

Few courts have tried to define how strong a connection is necessary to sustain a presumption, but it appears that they are making an effort in this direction. A recent district court decision did try to define this threshold question and required a surprisingly strong nexus.[38] The court felt that a presumption should in no way lighten the burden of proof and therefore must be abandoned if the relationship cannot be proved beyond a reasonable doubt.[39]

The most recent case in the series applying the *Tot* rule, *Leary v. United States,*[40] strikes down a presumption whereby all the elements of *knowingly* transporting marihuana are inferred from its possession.[41] The Court noted that the validity of a presumption is not a "matter within specialized judicial competence" and " 'significant weight should be accorded the capacity of Congress to amass the stuff of actual experience and cull conclusions from it.' "[42] However, the Court did consider a vast amount of empirical data in order to negate the presumption and indicated that if Congress did not limit presumptions to the "circumstances of life as we know them," the Court would.[43] It concluded that the presumption was " ' highly empirical,' "[44] and must be based on a consideration of all the available and pertinent facts. Thus, when ascertaining the constitutionality of a presumption the Court will keep three considerations in mind: the particular wording of the statute, the empirical bases of

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[37] *See* 8 WM. & MARY L. REV. 164 (1966).

[38] United States v. Adams, 293 F. Supp. 776 (S.D.N.Y. 1968).

[39] *Id.; but see* Caudillo v. United States, 253 F.2d 513 (9th Cir.), *cert. denied;* Romero v. United States, 357 U.S. 931 (1958); State v. Knudsen, 3 Conn. Cir. 458, 217 A.2d 236 (1965).

[40] 395 U.S. 6 (1969).

[41] The elements which are presumed from possession are that: (1) the marihuana was smuggled; (2) the defendant knew it was smuggled; and (3) it was smuggled with intent to defraud the United States. *Id.* at 37. 21 U.S.C. § 176(a) (1964) provides in part that: "Whenever on trial for a violation of this subsection, the defendant is shown to have or to have had the marihuana in his possession, such possession shall be deemed sufficient evidence to authorize conviction unless the defendant explains his possession to the satisfaction of the jury."

[42] 395 U.S. at 38, *quoting from* United States v. Gainey, 380 U.S. 63 (1965).

[43] *Id.* at 34, *quoting from* Tot v. United States, 319 U.S. 463, 468 (1943); *cf.* United States v. Romano, 382 U.S. 136 (1965); United States v. Gainey, 380 U.S. 63 (1965); Tot v. United States, 319 U.S. 463 (1943).

[44] 395 U.S. at 38; *cf.* United States v. Gainey, 380 U.S. 63, 67 (1965).

the inferences, and the determinations of Congress, if any, with respect to these bases.

In *Leary,* the Court indicated that the inference must necessarily be quite strong, saying "unless it can at least be said with *substantial assurance* that the presumed fact is more likely than not to flow from the proven fact on which it is made to depend," the statutory presumption will be deemed unconstitutional.[45] An analysis of the *Leary* decision indicates just how strong the connection between the actual facts and the presumption must be. The presumption of knowledge that the marihuana was of foreign origin was found invalid even though: (1) "most domestically consumed marihuana is still of foreign origin" — possibly as much as 90 percent;[46] and (2) there are five possible ways by which the consumer may become aware of the source. He may: (a) be aware of the high percentage of marihuana which is smuggled and deduce that his was illegally imported; (b) have smuggled the marihuana himself; (c) have specified that he wanted foreign marihuana when he bought it; (d) be able to tell from the appearance, packaging, or taste of the marihuana; or (e) know by indirect means that his supplier smuggled it.[47] These possibilities could obviously lead one to the presumption that the user knew the source of the marihuana. But in applying the test, the Court refused to uphold this presumption and held that there must be "substantial assurance" of a rational connection.[48]

It appears that the Court has adopted a strict application of the *Tot* rule. A number of statutes may therefore be in jeopardy as a result of the Court's stringent application of the test, specifically those statutes concerning smuggled goods, [49] kidnapping,[50] obscene

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45 395 U.S. at 36 (emphasis added). The Court uses the phrase "substantial assurances" for the first time in a case of this nature and seems to put a good deal of emphasis on it in that the term appears in the opinion at least three times. To determine how strong an inference must be in order to constitute a rational connection is necessarily difficult. However, one court has stated that a presumption should in no way lighten the burden of proof and therefore must be abandoned if not able to be proven beyond a reasonable doubt. United States v. Adams, 293 F. Supp. 776 (S.D.N.Y. 1968). *But see* Caudillo v. United States, 253 F.2d 513 (9th Cir.), *cert. denied,* Romero v. United States, 357 U.S. 931 (1958); State v. Knudsen, 3 Conn. Cir. 458, 217 A.2d 236 (1965), *appeal granted* 222 A.2d 810 (1966).

46 395 U.S. at 41. Ninety percent of all marihuana seized is said to be smuggled from Mexico, but this may in part reflect the positioning and activities of the federal authorities. *Id. See also* S. REP. NO. 1997, 84th Cong., 2d Sess. 7, 13 (1956); H.R. REP. NO. 2388, 84th Cong., 2d Sess. 14 (1956); BUREAU OF NARCOTICS, REPORT ON THE TRAFFIC IN OPIUM AND OTHER DANGEROUS DRUGS 67 (1965).

47 Leary v. United States, 395 U.S. 6 (1969).

48 *Id.* at 36.

49 18 U.S.C. § 545 (1964) provides that smuggling is presumed from possession of smuggled goods.

50 18 U.S.C. § 1201 (1964) provides that transportation in interstate commerce is presumed from a victim's absence for 24 hours.

publications,[51] narcotics,[52] heroin,[53] opium,[54] stills,[55] and firearms.[56]

It also appears from the holding of the Court that, in the future, statutory presumptions will be subject to attack wherever there is a question as to the empirical validity of the inference.[57]

II. THE PRIVILEGE AGAINST SELF-INCRIMINATION

The fifth amendment provides that; "No person ... shall be compelled in any criminal case to be a witness against himself. . . ."[58] This privilege has broadened since its inception, and has always been a "powerful symbol of individual liberty."[59] The protection from self-incrimination has no clear-cut standards implicit within it

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[51] 18 U.S.C. § 1465 (1964) provides that transportation of obscene publications for sale or distribution is presumed from possession of any five such publications.

[52] 21 U.S.C. § 174 (1964) provides that smuggling of a narcotic into the United States is presumed from its possession. 26 U.S.C. § 4724(c) (1964) provides that failure to register and pay special tax is presumed from narcotics possession. 26 U.S.C. § 4755(a)(2) (1964) provides that production of illegal marihuana is presumed from its presence on the land.

[53] 21 U.S.C. § 176(b) (1964) provides that illegal importation of heroin is presumed from its possession.

[54] 21 U.S.C. § 181 (1964) provides that illegal importation of opium is presumed from its possession.

[55] 26 U.S.C. § 5601(b)(3) (1964) provides that unlawful production of distilled spirits is presumed from one's presence at the place where mash, wort, or wash is being fermented. 26 U.S.C. § 5601(b)(4) (1964) provides that unlawful production of distilled spirits is presumed from one's presence at the site of a still.

[56] 26 U.S.C. § 5851(1) (1964) provides that unlawful receipt of firearms in violation of interstate commerce is presumed from their possession.

[57] In *Leary*, the Court went to great lengths to examine the probability of the validity of the presumption in light of the habits of marihuana users and indicated that this is a proper function of the Court, especially where the legislature's fact finding was not conclusive. 395 U.S. at 39. 18 U.S.C. § 837(c) (1964) is an example of how statutes could be written and probably withstand the test of constitutionality. It provides that:

> The possession of an explosive in such a manner as to evince an intent to use, ... damage or destroy any building ... creates rebutable presumptions that the explosive was transported in interstate or foreign commerce ... *provided, however,* that no person may be convicted under this section unless there is evidence independent of the presumption that this section has been violated.

[58] U.S. CONST. amend. V. The courts have construed the fifth amendment liberally. *See* Quinn v. United States, 349 U.S. 155 (1955); Hoffman v. United States, 341 U.S. 479 (1951); Gouled v. United States, 255 U.S. 298 (1921); Gilbert v. United States, 163 F.2d 325 (10th Cir. 1947). It has been held that this constitutional guarantee includes a freedom from prejudicial remarks about the defendant's silence. *See* Griffin v. California, 380 U.S. 609, *petition for rehearing denied,* 381 U.S. 957 (1965); De Luna v. United States, 308 F.2d 140 (5th Cir. 1962). The privilege is a personal right and does not apply to papers of a public nature. Thus, with exceptions such as required records, tax forms, licenses, and other records required under an *appropriate regulation* the immunity does not extend to all areas. *See* Shapiro v. United States, 335 U.S. 1 (1948); United States v. Sullivan, 274 U.S. 259 (1927); Amato v. Porter, 157 F.2d 719 (10th Cir. 1946), *cert. denied,* 329 U.S. 812 (1947). In defining an appropriate regulation, the required records doctrine has been limited to noncriminal and regulatory areas rather than areas permeated with criminal statutes. Haynes v. United States, 390 U.S. 85 (1968). *Cf.* Marchetti v. United States, 390 U.S. 39 (1968); Grosso v. United States, 390 U.S. 62 (1968).

[59] Meltzer, *Required Records, the McCarran Act, and the Privilege Against Self-Incrimination,* 18 U. CHI. L. REV. 687 (1951). *See also* Malloy v. Hogan, 378 U.S. 1 (1964); Mapp v. Ohio, 367 U.S. 643 (1961).

and "yields to no convenient formula."[60] Nevertheless, the courts have specified a number of guidelines. In order to invoke the privilege, the testimony in question must be compelled by some coercive force, legal or factual.[61] Both oral and written testimony are treated equally;[62] however, the privilege is limited to "testimonial" or "communicative" evidence (diaries, letters, other written communications, or statements) rather than "real" and "physical" evidence (blood tests, handwriting and voice tests, and a large number of other police investigatory techniques).[63] The privilege has been held to apply to any testimony which would furnish "a link in the chain of evidence needed to prosecute. . . ."[64] However, there are limitations placed upon the privilege. For example, until recently a person's communications with the government (*e.g.*, registration or income and excise tax forms) were outside the privilege and

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[60] McKay, *Self-incrimination and the New Privacy,* 1967 SUP. CT. REV. 193, 194; *see generally* 3 J. WIGMORE, EVIDENCE § 2250 (McNaughton rev. ed. 1961); Kalven, *Invoking the Fifth Amendment: Some Legal and Impractical Considerations,* 9 BULL. ATM. SCI. 181 (1953); Kamisar, *A Dissent from the Miranda v. Arizona Dissent; Some Comments on the "New" Fifth Amendment and the Old "Voluntariness" Test,* 65 MICH. L. REV. 59 (1966); Morgan, *The Privilege against Self-incrimination,* 34 MINN. L. REV. 1 (1949); Pittman, *The Colonial and Constitutional History of the Privilege Against Self-incrimination in America,* 21 VA. L. REV. 763 (1935); Symposium, *Some Views on Miranda v. Arizona,* 35 FORDHAM L. REV. 169 (1966); Note, 45 DENVER L.J. 427 (1968).

[61] Hoffa v. United States, 385 U.S. 293 (1966); United States v. Knohl, 379 F.2d 427 (2d Cir. 1967). Where the defendant was a juvenile, the court found psychological domination by the authorities sufficient to satisfy the necessity of compulsion, indicating that youths must be treated with even greater care. *In re Gault,* 387 U.S. 1 (1967).

[62] Albertson v. Subversive Activities Control Bd., 382 U.S. 70 (1965); People *ex rel.* Ferguson v. Reardon, 197 N.Y. 236, 90 N.E. 829 (1910).

[63] This distinction has recently been the subject of a large amount of litigation particularly as to handwritten samples which have been deemed to be physical and real evidence and thus not within the privilege. Granza v. United States, 381 F.2d 190 (5th Cir.), *cert. denied,* 389 U.S. 939 (1967); Weaver v. United States, 379 F.2d 799 (8th Cir.), *cert. denied,* 389 U.S. 962 (1967); United States v. Serad, 367 F.2d 347 (2d Cir. 1966), *vacated,* 390 U.S. 1034 (1968); Shelton v. United States, 205 F.2d 806 (5th Cir. 1953), *cert. dismissed,* 346 U.S. 892 (1953), *motion denied,* 349 U.S. 943 (1955). *But see* Lewis v. United States, 382 F.2d 817 (D.C. Cir.), *cert. denied,* 389 U.S. 962 (1967); United States v. Green, 282 F. Supp. 373 (S.D. Ind. 1968). Some types of evidence, considered to be real and physical, is outside the scope of this privilege, *e.g.:* fingerprints—Pearson v. United States, 389 F.2d 684 (5th Cir. 1968); United States *ex rel.* O'Halloran v. Rundle, 384 F.2d 997 (3d Cir. 1967); United States v. Laub Baking Co., 283 F. Supp. 217 (N.D. Ohio 1968); stand and give name—Stovall v. Denno, 388 U.S. 293 (1967); Cowans v. Warden Md. Penitentiary, 276 F. Supp. 696 (D. Md. 1967); blood samples—Schmerber v. California, 384 U.S. 757 (1966); Brent v. White, 276 F. Supp. 386 (E.D. La. 1967); psychological examination—United States v. Albright, 388 F.2d 719 (4th Cir. 1968); Early v. Tinsley, 286 F.2d 1 (10th Cir. 1960), *cert. denied,* 365 U.S. 830 (1961), *rehearing denied,* 365 U.S. 890 (1961); police line up—United States v. Hutto, 393 F.2d 783 (4th Cir. 1968); Schmidt v. United States, 380 F.2d 22 (5th Cir. 1967), *cert. denied,* 390 U.S. 908 (1968); Gilbert v. United States, 366 F.2d 923 (9th Cir. 1966), *cert. denied,* 388 U.S. 922 (1967); voice identification—Biggers v. Tennessee, 390 U.S. 404 (1968); Wise v. United States, 383 F.2d 206 (D.C. Cir. 1967), *cert. denied,* 390 U.S. 964 (1968).

[64] Hoffman v. United States, 341 U.S. 479, 486 (1951); Blau v. United States, 340 U.S. 159, 161 (1950); United States v. King, 402 F.2d 694 (9th Cir. 1968). *See also* United States v. Klehman, 397 F.2d 406 (7th Cir. 1968), *cert. denied,* 343 U.S. 987 (1969).

thus had to be filed regardless of their nature.[65] However, *Leary* is the fourth in a series of recent decisions wherein the privilege has been extended to include excise tax registrations if such disclosures are likely to lead to arrest or conviction.[66]

In *Leary,* the Court found "real and appreciable risk of self-incrimination"[67] based on the fact that an individual's coming forward and registering makes him highly suspect and increases the possibility of investigation.[68] Also, the information required was "in an area permeated with criminal statutes, where response to any of the form's questions in context might involve the petitioners in the admission of a crucial element of a crime."[69] Not only does the Secretary of the Treasury become aware of the individual's activities, but these activities become a matter of public record as well.[70]

In light of the fact that 48 states have statutes restricting the distribution and use of marihuana,[71] Justice Black has described the

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[65] *See* United States v. Forgett, 349 F.2d 601 (6th Cir. 1965), *vacated and remanded,* 390 U.S. 203 (1968) (bringing the case in alignment with the *Haynes* decision); United States v. Eramdjian, 155 F. Supp. 914 (S.D. Cal. 1957); *cf.* Myres v. United States, 174 F.2d 329 (8th Cir.), *cert. denied,* 338 U.S. 849 (1949). It was felt that the government needed information to carry on its day to day business and that it must be able to compel disclosure so that the information would be received in a timely manner. The government's argument breaks down when a tax is a tax only on its face, collecting only negligible revenue, but is in fact a regulatory statute. *See generally* Mansfield, *The Albertson case: Conflict Between the Privilege Against Self-incrimination and the Government's Need for Information,* 1966 SUP. CT. REV. 103; McKay, *Self-incrimination and the New Privacy,* 1967 SUP. CT. REV. 193.

[66] Marchetti v. United States, 390 U.S. 39 (1968); Grosso v. United States, 390 U.S. 62 (1968); Haynes v. United States, 390 U.S. 85 (1968). A number of other decisions have also considered this question and reached similar results. *See* United States v. Covington, 395 U.S. 57 (1969); United States v. Walden, No. 12,849 (4th Cir., June 10, 1969); United States v. Freeman, 412 F.2d 1180 (10th Cir. 1969); Lewis v. United States, 408 F.2d 1310 (10th Cir. 1969); Whaley v. United States, 394 F.2d 399 (10th Cir. 1968), where the privilege, though recognized, was found to be waived because of lack of proper assertion.

[67] 395 U.S. at 16. In *Marchetti* the court said: "The central standard for the privilege's application has been whether the claimant is confronted by substantial and 'real,' and not merely trifling or imaginary, hazards of incrimination." 390 U.S. 39, 53 (1968). *See also* Rogers v. United States, 340 U.S. 367 (1951); Brown v. Walker, 161 U.S. 591 (1896).

[68] 395 U.S. at 18. *See generally* Mansfield, *The Albertson Case: Conflict Between the Privilege against Self-incrimination and the Government's need for Information,* 1966 SUP. CT. REV. 103; McKee, *The Fifth Amendment and the Federal Gambling Tax,* 5 DUKE B.J. 86 (1956).

[69] Albertson v. Subversive Activities Control Bd., 382 U.S. 70, 79 (1965); *see also* Leary v. United States, 395 U.S. 6 (1969); Marchetti v. United States, 390 U.S. 39, 47 (1968); Grosso v. United States, 390 U.S. 62, 64 (1968).

[70] INT. REV. CODE of 1954 § 4773 provides that:

> [S]tatements or returns . . . shall be open to inspection by officers and employees of the Treasury Department duly authorized for that purpose, and such officials of any State or Territory, or of any organized municipality therein . . . as shall be charged with the enforcement of any law or municipal ordinance regulating the production of marihuana or regulating the sale, prescribing, dispensing, dealing in, or distribution of narcotic drugs or marihuana.

[71] These states have enacted a prohibition similar to the provisions of the UNIFORM NARCOTIC DRUG ACT. *See* 9B UNIFORM LAWS ANN. 409-10 (1966). Section 2 of this act provides: "It shall be unlawful for any person to . . . possess . . . any narcotic drug, except as authorized in this act." Section 1(14) includes "cannabis" in the category of "narcotic drugs."

effect of federal registration statutes as a "squeezing device contrived to put a man in federal prison if he refuses to confess himself into a state prison . . . ."[72]

Presuming that tax measures are valid,[73] the courts have traditionally deferred to Congressional power; "[s]o long as Congress acts in pursuance of its constitutional power, the judiciary lacks authority to intervene on the basis of the motives which spurred the exercise of that power."[74] This freedom gives Congress a great deal of power because "[e]very tax is in some measure regulatory. To some extent it imposes an economic impediment on the activity taxed as compared with others not taxed."[75] However, the Supreme Court has recently stated: "This Court must give deference to Congress' taxing powers, and to measures reasonably incidental to their exercise; but we are no less obliged to heed the limitations placed upon those powers by the Constitution's other commands."[76] Thus, the freedom from self-incrimination will provide a complete defense to a registration requirement unless there is no substantial risk of self-incrimination,[77] the plea is untimely,[78] or the privilege has been waived.[79]

The successful invocation of this privilege in a number of taxation areas (*e.g.*, the excise taxes on gambling, firearms, and marihuana) indicates that the Court has considered the question carefully and even in light of the changing complexion of the Court, the ques-

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[72] United States v. Kahriger, 345 U.S. 22, 36 (1953) (dissenting opinion). Justice Black's dissent became the accepted view when *Kahriger* was overruled by *Marchetti v. United States,* 390 U.S. 39, 54 (1968).

[73] *See* Helvering v. Gerhardt, 304 U.S. 405 (1938); Binns v. United States, 194 U.S. 486 (1904); Nicol v. Ames, 173 U.S. 509 (1899).

[74] Barenblatt v. United States, 360 U.S. 109, 132 (1959). *Cf.* United States v. Sanchez, 340 U.S. 42 (1950); Sonzinsky v. United States, 300 U.S. 506 (1937); Costellano v. United States, 350 F.2d 852 (10th Cir. 1965), *cert. denied,* 383 U.S. 949 (1966).

[75] Sonzinsky v. United States, 300 U.S. 506, 513 (1937). The use of taxing measures to regulate behavior is frequently used. This device has generally been held to be constitutional. "[A] tax does not cease to be valid merely because it regulates, discourages, or even definitely deters the activities taxed." United States v. Sanchez, 340 U.S. 42, 44 (1950). *See also* McCray v. United States, 195 U.S. 27 (1904).

[76] Haynes v. United States, 390 U.S. 85, 98 (1968). *See also* United States v. Covington, 395 U.S. 57 (1969); Leary v. United States, 395 U.S. 6 (1969); Marchetti v. United States, 390 U.S. 39 (1968).

[77] Risk of incrimination is an absolute necessity to the application of this privilege and where the activity involved is not illegal (*i.e.,* liquor manufacture and sales) there is no defense available to a charge of failure to register and pay the tax. *See* Anderson v. United States, 403 F.2d 206 (5th Cir. 1968); Shoffeitt v. United States, 403 F.2d 991 (5th Cir. 1968), *cert. denied,* 393 U.S. 1094 (1969); Brown v. United States, 401 F.2d 769 (5th Cir. 1968), *cert. denied,* 394 U.S. 962 (1969).

[78] United States v. Covington, 395 U.S. 57 (1969). The Court has held that "A plea on motion to dismiss the indictment is plainly timely." *Id.* at 60.

[79] *See* 18 U.S.C.A. rule 12(b)(3) (1969). A defendant may waive the privilege against self-incrimination; this waiver must be made voluntarily, intelligently, and with full knowledge of his rights. *See* Gardner v. Broderick, 392 U.S. 273 (1968); Miranda v. Arizona, 384 U.S. 436 (1966); United States v. Neilsen, 392 F.2d 849 (7th Cir. 1968).

tion will continue to be answered in a like manner.[80] By invalidating the registration requirement under the *Marihuana Tax Act,* the Court has cast doubt on the validity of a number of other statutes.[81] Similarly, the Court's willingness to invalidate a tax act puts Congress on notice that the Court will not allow Congress to do indirectly, through taxation, what it could not do directly.[82] Moreover, this decision seems to signal at least a temporary return to an earlier position of the Court where tax measures were scrutinized carefully in order to determine if they were a proper exercise of the tax power.[83]

The *Leary* decision is well founded in reason and justice. There appears to be no reason to allow Congress to circumvent the dictates of the Constitution by use of its taxing power. Unquestionably, the freedom from self-incrimination is so fundamental to our values that the court should and will go to great lengths to protect this and all other rights.

Vance E. Halvorson

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[80] Only two justices of the Court, Chief Justice Warren and Justice Stewart, have expressed reservations as to the self-incrimination issue, thus it appears that a strong majority of the court approves of the discussion and will be of like mind in the future. Leary v. United States, 395 U.S. 6 (1969).

[81] In the past, a number of registration requirements have been challenged, although on the whole unsuccessfully, *e.g.:* United States v. Toussie, 280 F. Supp. 473 (E.D.N.Y. 1967); Foreign Agents Registration Act—22 U.S.C. § 612 (1958), *see* United States v. Peace Information Center, 97 F. Supp. 255 (D.D.C. 1951); distilleries—26 U.S.C. §§ 5173, 5179, 5222, 5801 (1964), *see* United States v. Young, 284 F. Supp. 1008 (E.D. Tenn. 1968); United States v. McGee, 282 F. Supp. 550 (M.D. Tenn. 1968).

[82] When the *Marihuana Tax Act* was passed, Congress was fully aware of the publicity a user would receive from registration yet it did not really consider the implication in light of the privilege against self-incrimination.

> Two objectives have dictated the form of H.R. 6906, first, the development of a plan of taxation which will raise revenue and at the same time render extremely difficult the acquisition of marihuana by persons who desire it for illicit use, and second the development of an adequate means of publicizing dealings in marihuana in order to tax and control the tax effectively.

H.R. REP. No. 792, 75th Cong., 1st Sess., 2 (1937). *See also* S. REP. No. 900 75th Cong., 1st Sess., 103 (1937). The Court does not challenge Congress' powers of taxation, but it demands that the methods used be "entirely consistent with constitutional limitations. . . ." Haynes v. United States, 390 U.S. 85, 98 (1968).

[83] *See* Child Labor Tax Case, Bailey v. Drexel Furniture Co., 259 U.S. 20 (1922); Hill v. Wallace, 259 U.S. 44 (1922); Knowlton v. Moore, 178 U.S. 41 (1900); McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819). *McCulloch* was the first case in which the Court exercised power of judicial review over congressional legislation and since that case was decided, the Court has broadly expanded the use of that power.

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